QUARTER 01 2020

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CONSIDER THIS

VISION 2020: REASONS TO BE OPTIMISTIC ABOUT RETURNS

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Consider this **Q1 2020**

We'd love to hear your thoughts on the new format of our *Consider this* magazine. For this reason we ask that you please take a few moments to complete a short survey consisting of only 5 questions. To start the survey, please click on the "Survey" button below.

SURVEY

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Letter from the CEO

Benard Fick
CHIEF EXECUTIVE

Welcome to the first edition of our digital-only version of "Consider This" for the first quarter of 2020. We trust that you will enjoy this greener, more sustainable and more flexible platform that we can tailor to better meet your interests. Rest assured that we remain committed to providing the same high-quality articles offering our investment views, investor education and personal finance insights that the printed version offered.

Global equities end 2019 with good gains

Turning firstly to 2019 market developments: after a tough three quarters of 2019, the final quarter of the year proved to be more positive for South African investors thanks to some progress made in the US-China trade war and some finality being reached around the Brexit saga. The Conservative party's decisive win in the December United Kingdom general election provided a clear mandate to that government to conclude the UK's exit from the European Union by 31 January 2020, notwithstanding the disruption this will cause.

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These developments propelled global equities to their strongest annual returns in a decade, with the MSCI All Country World Index returning 26.6% in US dollars for the year, as shown in the table. Emerging market equities and currencies were also boosted by the renewed bullish sentiment. Equally, global bonds delivered a surprisingly strong 6.8% total return for the year, considering the high prices at which they started. This environment provided support to the performance of the **Prudential Global Funds range**, into which the offshore portions of our South African client portfolios are invested.

SA benefits from bullish sentiment

South African equities and the rand were also beneficiaries of the more positive global mood, helping to offset negative local developments during Q4. However, the resumption of load-shedding was a significant setback to our hopes for increased economic growth.

The FTSE/JSE All Share Index produced a 13.3% return for the quarter and 12.0% over 2019 on a total return basis, while the FTSE/JSE Capped SWIX Index (which caps single shares to a maximum index weight of 10%) delivered 5.3% and 6.8%, respectively.

Asset class	Total return Q4 2019 (Rand and US$)	Total return 2019 (Rand and US$)
SA equity – FTSE/JSE All Share Index (Rand)	4.6%	12.0%
SA equity – FTSE/JSE Capped SWIX All Share (Rand)	5.3%	6.8%
SA listed property – FTSE/JSE SAPY (Rand)	0.6%	1.9%
SA bonds – BEASSA All Bond Index (Rand)	1.7%	10.3%
SA inflation-linked bonds – JSE CILI Index (Rand)	-0.9%	2.6%
SA cash - STeFI Composite Index (Rand)	1.7%	7.3%
Global equity – MSCI All Country World (Total) (US$ net)	9.0%	26.6%
Global equity – MSCI World (Developed) (US$ net)	8.6%	27.7%
Global equity – MSCI Emerging Markets (US$ net)	11.8%	18.4%
Global bonds – Bloomberg Barclays Global Aggregate Bond Index (US$)	0.5%	6.8%
Global property – FTSE EPRA/NAREIT Global Property REIT Index (US$ net)	0.8%	23.0%

SOURCE: Morningstar

This substantial differential, and our reasons for preferring the Capped SWIX benchmark in managing our funds, are explained in an **accompanying article** by our Head of Quantitative Analysis, Clare Lindeque.

Despite local corporate earnings broadly surprising to the upside, our market did not experience a similar re-rating to that in most other global equity markets, including our emerging market peers. Foreign (and local) investors remain rightly concerned about South Africa's slow economic growth, government finances, Eskom and further credit rating downgrades going forward.

Listed property recorded another poor year, producing 0.6% for Q4 and 1.9% for 2019. South African bonds delivered a 1.7% return in Q4 and a commendable 10.3% for the year. The gains were driven largely by falling inflation throughout the year – November CPI reached a nine-year low at 3.6% year-on-year. South African bonds' high real yields relative to most other countries did attract buying from yield-seeking investors. Cash (as measured by the STeFI Composite) delivered 1.7% and 7.3%, respectively. Finally, the rand gained ground in Q4 against all three major global currencies, along with other emerging markets, and for the year it appreciated 2.7% versus the US dollar and 4.5% against the euro, but lost 0.5% against the pound sterling.

Prudential wins Raging Bull award

Looking at our fund performance, first of all I'm pleased to report that the **Prudential Global Inflation Plus Feeder Fund** has won a Raging Bull Certificate for its risk-adjusted performance over five years to 31 December 2019 as the "Best (SA-domiciled) global multi-asset low equity fund".

The fund is a rand-denominated fund investing (or feeding) directly into our **Prudential Global Inflation Plus Fund**, part of the **Prudential Global Funds range** of four offshore Irish-domiciled US-dollar global funds. The range is managed by our largest shareholder, London-based M&G Investments. The award is testimony to the long experience and skills of the large investment team at M&G Investments, as well as the benefits of having a fund range designed specifically for South African investors.

Prudential fund performance

On a more general note, while the absolute investment returns from

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Prudential fund performance to 31 December 2019

Asset class	1-year Return %	3-year Return p.a. %	5-year Return p.a. %	10-year Return p.a.%
Equity Fund	6.6	4.5	4.4	10.7
Benchmark	8.0	3.5	2.9	8.5
Dividend Maximiser Fund	10.0	5.3	4.7	10.4
Benchmark	8.0	3.5	2.9	8.5
Core Value Fund	3.9	4.0	5.1*	11.0*
Benchmark	6.8	4.1	4.0	9.8
Enhanced SA Property Tracker Fund	0.3	-5.0	0.8	10.5
Benchmark	1.9	-3.7	1.2	10.8
Balanced Fund	8.8	5.6	5.8	10.4
Benchmark	9.5	5.1	4.8	8.4
Inflation Plus Fund	6.4	3.7	4.6	9.1
Benchmark	7.0	7.9	8.3	8.5
Enhanced Income Fund	7.7	6.8	6.9	8.0
Benchmark	7.3	7.4	7.2	7.3
Income Fund	8.7	8.6	N/A	N/A
Benchmark	7.3	7.4		
Global Equity Feeder Fund	19.0	9.8	10.2	13.1
Benchmark	23.2	13.3	12.6	16.0
Global Balanced Feeder Fund	15.9	N/A	N/A	N/A
Benchmark	16.8			
Global Inflation Plus Feeder Fund	11.7	6.5	7.0	8.7
Benchmark	-1.1	2.3	4.9	7.2
Global Bond Feeder Fund	6.0	4.5	5.5	9.5
Benchmark	4.0	5.0	6.3	9.2

SOURCE: Morningstar

*Core Value Fund reflects zero-fee B Class returns for 5 and 10 years only. All other funds are A class returns (shown after all fees and charges).

our funds did improve from 2018, 2019 was still a fairly disappointing year in terms of fund performance. Absolute fund returns reflected the weak economic conditions prevalent in South Africa while, somewhat counter-intuitively, rand appreciation detracted from the stronger returns of our offshore holdings.

Our relative fund performances, when compared to their benchmarks, were also disappointing over the 2019 calendar year, following on a very strong set of relative returns in 2018.

On the positive side, our funds benefitted from our overweight positioning in global equities and underweight in global fixed income, plus select holdings in large international rand-hedge shares such as British American Tobacco, Anglo American, Richemont and Naspers. However, detracting from value, when compared to our benchmarks, were our overweight positions in Sappi and Sasol and underweight positions in precious metals producers like Sibanye Gold, Implats, Amplats and Northam.

While it is always easier to discuss our positions that added value, some investment ideas did cause portfolio underperformance. When this happens, our approach is to carefully reconsider our investment case, to determine: (a) whether we made a mistake in our analysis; or (b) whether our analysis remains defendable. If it is the former, we should reduce or close our positions. But when it is the latter, we should hold our positions or even add thereto, even though that is emotionally a very tough thing to do. Below are very brief summaries of our two largest single stock detractors over the year, and our arguments for still holding these positions in our client funds:

Sappi
Sappi Limited, the South African-based paper company, was one of the top contributors to performance for the final quarter of 2019, but the largest detractor from performance for the full year over most of our client portfolios. We have held Sappi for several years based on an investment case premised on the company paying down its large debt balance and having considerably lowered the cost of this debt which it accumulated during the financial crisis. We recognised that Sappi was aggressively allocating capital away from its declining paper business and investing heavily in its dissolving pulp business. (Dissolving pulp is the product mainly used in the production of clothing and has been growing quickly as a cheaper alternative to cotton.) Until 2019, this investment case had played out well, as Sappi has paid off and refinanced debt to much lower levels of interest and is now making well over half its profits from dissolving pulp. Most importantly, Sappi has resumed paying dividends and this had underpinned its share price recovery.

Unfortunately though, the price of dissolving pulp dropped significantly in 2019 (with a rebound in the final quarter), and the market penalized the Sappi share price as result. In our analysis, this market reaction was overdone. Our investment case

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remains intact, only somewhat delayed. While we remain cognisant of the risks that Sappi faces with respect to falling paper demand and the global trade conflict, the company is a major global supplier of cellulose pulp, and generates very good margins from this business, in spite of the lower prices now being achieved. Sappi also continues to generate strong cash flows. On a valuation basis, Sappi is near the most attractive levels we have seen in last decade. At the same time, it is also in a far better financial position than it has been in the last 10 years and paying sustainable dividends.

Sasol

Our overweight position in Sasol was a detractor to fund returns over 2019, both in absolute and relative terms. Its share price rallied in the latter part of the fourth quarter of 2019, with the successful replacement of the reactor catalyst at the ethane cracker of the Lake Charles chemicals project (LCCP), but this did not offset losses earlier in the year, when the company surprised the market with a huge US$1.1 billion spending overrun for the project. The LCCP has been a continual disappointment for the company and us as shareholders as it has run significantly over budget and behind schedule. And now that the project is finally on-stream, Sasol is ramping up production into a weaker chemicals market than when the project commenced. The poor execution of this project has cost shareholders a significant amount, and led to the departure of a number of very senior Sasol executives.

Our investment case is based on:

- Solid earnings from the company's existing operations (although with a weaker balance sheet) that support earnings per share; and
- Improving cash flow after the completion of the LCCP project beginning to contribute positively to earnings. Although the higher-than-expected debt (which will now take longer to pay off) and the slower ramp-up to "steady-state" earnings does dampen the benefit compared to our prior expectations, cash flow is not expected to be impacted as much because the group will postpone additional planned capital investment for other projects to compensate for the extra US$1.1bn Lake Charles expenditure.

More positively, Sasol was able to increase its debt covenants and the strength of the oil markets in the fourth quarter of 2019 has lowered the risk of a capital call from shareholders.

We still expect a significant "cashflow inflection point" for the company in 2020/21, when positive operating profit from LCCP replaces significant capital spending to build the plant. The cash flows that the project will generate should be able to adequately pay down debt. However, the risk of dividends being cut has increased. In fact, it might be the best course of action for Sasol to temporarily suspend dividends in order to further pay off debt and rebuild its balance sheet.

In our view, a share price correction was warranted following the LCCP challenges, but it has been overdone. Sasol's capital allocation plan commits the company to further reducing its debt through asset sales, as well as curtailing its further capex spending. As such, its balance sheet strength is set to improve further along with free cash flow. Our current assessment is therefore that our Sasol investment case still holds, but we acknowledge it has become slightly less convincing.

Asset Allocation Decisions Added Value in 2019

Across our multi-asset Balanced and Inflation Plus Funds we continued to hold a meaningful exposure to domestic and global equities, especially as the former's valuation became cheaper over the year. In fact, over 2019 we added to our SA equity exposure as valuations fell. Despite their underperformance, we remain convinced that over the longer term, equities will deliver superior real returns.

We remained underweight in listed property for the year given the higher risks to earnings going forward despite the apparently attractive valuations prevailing. The sector faces ongoing headwinds arising from pressure on landlords to reduce their rentals, due to both weak consumer spending and office oversupply. In retrospect, we should have been even further underweight.

Also adding to performance across most of our multi-asset portfolios in 2019 was our overweight holding in South African nominal bonds, which offered an attractive real return of over 5.0%. However, we did miss out on some additional return through

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our preference for longer-dated bonds beyond 10-years, which did not perform as well as their shorter-dated counterparts.

Looking to 2020

It is disappointing that nearly two years after "Ramaphoria" little progress has been made on structural reforms or state-owned enterprises (SOEs) finances – and Eskom blackouts have returned to further weigh on growth. Not surprisingly, consumer and business confidence remain depressed and we suspect the consumer will remain under pressure in 2020. Consequently, we don't deny that South African risks remain high, and growth expectations subdued. Notwithstanding this, our financial markets look to price the future, and with most local asset class valuations looking very cheap - in particular, equity valuations approaching all-time lows - perhaps even modest indications of progress could produce reasonably good returns for investors.

As long-term valuation-based investors, we have been using this opportunity to add cheap holdings in quality companies to our client portfolios. This should bode well for future returns over the medium term. Sandile Malinga, portfolio manager, discusses our return outlook in more detail in our **Table Talk** feature in this edition.

In these challenging times, we promise to remain patient, keep a long-term outlook and follow our consistent investment process to deliver competitive, inflation-beating returns for all our clients.

We hope you enjoy this Q1 2020 edition of Consider this, and as always welcome any feedback you may have.

Bernard

Bernard joined Prudential in 2008 as Head of Institutional Business and was appointed as Chief Executive Officer in 2010. With more than 27 years of industry experience, Bernard previously worked at Alexander Forbes in a range of leadership roles, including Managing Director of the Namibian business as well as Head of the Asset Consulting Division. Bernard holds a Bachelor of Commerce degree in Maths and Actuarial Science from Stellenbosch University and is a Fellow of the Institute and Faculty of Actuaries and the Actuarial Society of SA.

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TABLE TALK

Sandile Malinga Portfolio Manager at Prudential Investment Managers, explains to investors why there are some reasons to be optimistic about returns for 2020, despite the gloomy conditions.

KEY TAKE-AWAYS

- SA asset valuations are very cheap on an historic basis, particularly equities, at levels similar to those seen during the Global Financial Crisis.
- We believe asset prices are reflecting overly pessimistic sentiment. At some point prices (and valuations) will have to catch up with actual earnings growth, offering good opportunities for investors. Our analysis points to potential returns of 8% over inflation from equities over the next 3-5 years.
- Our bond yields are reflecting what we believe to be an excessive risk premium that we are taking advantage of, especially in longer-dated tenors.
- Listed property is attractively valued but presents earnings risk due to the weak growth environment.

Q The South African government doesn't seem to be making much progress in reforming the economy and improving government finances to get us back on the path to faster growth. Do investors have any reason to be optimistic about returns for 2020?

A Although we certainly wouldn't lay claim to being able to predict the future, at Prudential we do think investors have a good reason to be cautiously optimistic about prospective returns from South African equities (excluding the property sector) and bonds over the next three to five years. This is despite the very poor investor sentiment surrounding South African assets, and is grounded in the cheap valuations available to investors at the start of 2020.

Our equity market in particular has been driven down to very cheap levels after some five years of disappointing returns. In fact, in 2019 it was the only market in the world to have de-rated in the face of consistently positive company earnings growth surprises. All other equity markets re-rated, some without the positive earnings news. Such market dynamics are highly unusual, telling us that negative market sentiment towards South Africa is the primary factor driving our market, overwhelming actual positive earnings results. However, we know that fundamentally, equity markets are driven by earnings growth over time, and eventually this will underpin our own market.

SA equities very attractive

Looking at one equity valuation measure, South Africa's 12-month forward Price-Earnings ratio (P/E) has been gradually falling since mid-2015, from over 16X to around 11X, a cheap level on an historic basis. Although earnings have been growing, share prices have been largely flat over that period, leading to a de-rating of the market.

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Meanwhile, on a Price-Book Value (P/B) basis, South African equities started 2020 trading at 1.7X, far cheaper than their 2.1X historic average. Looking back at historic equity returns from this valuation point since 1980, on average investors have received subsequent five-year returns of 22% p.a., a handsome return. Of course there has been a wide range of results around this average over the 40-year period, from a low of around 7% p.a. to around 38% p.a. Still, current valuations are more in investors' favour now to receive above-average returns, based on the probability distribution of future returns.

Finally, using a third valuation measure, that of Prudential's analysis of asset class fair value over time, local equities are trading well below their long-term fair value, and could deliver a real return in the region of 8.0% p.a. over the next three to five years from their current valuation level. We do not know how or when these returns could be delivered, only that history says they are likely to be improved after such a unprecedently long period of equity underperformance relative to cash returns and versus the market's own history.

"...South Africa's nominal bonds are also likely to provide very attractive returns over the next three to five years based on their current cheap valuations"

SA bonds offering excessive risk premium

Equity performance is not the only area where we are cautiously optimistic – South Africa's nominal bonds are also likely to provide very attractive returns over the next three to five years based on their current cheap valuations (low prices and elevated yields). Our 20-year government bond was offering a real yield of 4.5% at the start of 2020, a very high level that was reached only at the beginning of inflation targeting in 2000 and briefly again after the Global Financial Crisis (GFC) in 2008. This is 3.5% higher than the real yield on the 20-year US Treasury and 4.5% more than that offered by the 20-year German bund – the highest differentials since 2000.

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This shows that there is currently an extraordinarily high risk premium built into our bond market, manifesting the very poor investor sentiment surrounding our assets. We believe the magnitude of this premium isn't merited – certainly the country has been in worse circumstances, for example during the GFC. Also, our bond yields are higher than those in other emerging markets with poorer credit ratings and more serious issues than ours, such as Venezuela, Argentina, Turkey and Indonesia. Based on Prudential's long-term fair value analysis, we would expect South African bonds to deliver a real return in the region of 3.9% p.a. over the next three to five years.

Caution on listed property

For South African listed property, however, our view is much more cautious. Going into 2020, this sector is certainly valued at attractive levels, with our valuation analysis pointing to a prospective real return of around 8.4% p.a. over the next three to five years. Despite this, we are concerned about the earnings outlook for listed property companies, as they face ongoing headwinds from pressure on landlords to reduce their rentals, particularly in the retail space where retailers are grappling with sluggish consumer spending. Equally, oversupply in office space is negative for listed property earnings currently. We consider earnings expectations to be vulnerable to disappointments, and as such we are underweight in listed property in many of our client portfolios.

Emerging market equities cheap

Turning to global investments, we do still see opportunities for good returns from global equities despite their strong performance in 2019, particularly when viewed against global bonds. Global equities (as represented by the MSCI All Country World Index (ACWI) are trading on a P/B ratio of 2. 6X. Although this is not absolutely cheap based on their history, they are offering an earnings yield of around 6.0%, which is very attractive compared to the 0% real yield from US Treasuries and the -2.0% real yield from German bunds. We believe US equities are expensive, and that better opportunities exist

– particularly in emerging market equities, which have underperformed the US market for several years. In contrast, we are avoiding developed market government bonds with near-zero to negative real yields, and prefer to hold US and European corporate bonds.

In conclusion, we would urge investors not to be caught up in the very pessimistic sentiment surrounding South African assets at the start of 2020. In fact, valuations across most of our local asset classes are cheap relative to offshore assets and based on their own history. At Prudential, we have been taking advantage of this opportunity by adding to our client portfolios where appropriate, and we would encourage investors with medium- to longer-term timeframes to do the same. We would suggest speaking with your financial adviser to determine how best to benefit from the opportunity now presenting itself. ■

Sandile joined Prudential in 2013 and is the joint-Portfolio Manager of several Prudential funds. With 12 years' industry experience, Sandile previously worked at Investec Asset Management as a portfolio manager on institutional fixed interest client mandates and also served as a fixed interest dealer and analyst. He holds a Bachelor of Science degree in Mathematical Statistics and Actuarial Science from the University of Witwatersrand and is a student member of the Institute and Faculty of Actuaries.

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Is South Africa approaching an IMF bailout?

David Knee
CHIEF INVESTMENT OFFICER

KEY TAKE-AWAYS

- There is no widely accepted "magic number" for debt levels at which a country needs to be bailed out.
- While SA's government debt/GDP ratio is high, our foreign currency debt is low. It is the ability to repay this debt that primarily determines whether a bailout is necessary.
- SA is able to repay its bonds, and has few of the other symptoms that accompany a debt crisis, such as very high inflation and a rapidly depreciating currency.

In the wake of the gloomy numbers contained in Finance Minister Tito Mboweni's Medium-Term Budget Policy Statement (MTBPS), there is increasing concern among investors that South Africa will have to turn to the International Monetary Fund (IMF) for a bailout to fund the country's growing debt levels.

In the MTBPS, the government budget deficit showed a worrying increase to -5.9% of GDP from -4.5% for the current financial year, peaking at -6.5% next year and returning to -5.9% in 2022/23. At the same time, the total debt burden was adjusted higher at 61% of GDP from 57% in the current year, and rising to 71% by

2022/23 in the absence of any further measures to constrain expenditure or raise revenue. Investors and the global credit rating agencies were disappointed by Mboweni's failure to show a clear path toward reducing debt levels over the next three years in the face of still-sluggish GDP growth and high spending requirements. It also increased the likelihood of further credit rating downgrades to come, a fact subsequently confirmed in the responses of Moody's and S&P, where they noted the deterioration and potential for further downgrades if no action is taken.

In reaction, both the rand and local bonds sold off to reflect these concerns. But despite it all, are we really approaching a fiscal cliff and the need for an IMF bailout? Is there a debt level at which countries are "automatically" considered to have reached a debt crisis?

"SA's domestic bond market has the second-longest maturity profile in the world."

High debt levels – an international perspective

It turns out that there is no agreed "magic number" for a country's debt/GDP level at which it becomes "too high" and will negatively impact the economic growth rate, or will require an IMF bailout. All countries have a unique story. However, there are indicative academic studies that can provide direction for South Africa. Some of those undertaken after the GFC focusing on the impact of gross debt levels on economic growth have found that there has been a weak relationship between the two. They did find, however, that once a nation's debt/GDP ratio passes 90%, the impact on economic activity from the government taking on additional debt is negative. This is corroborated by research by the European Central Bank (ECB) and the Bank for International Settlements (BIS).

If we look at Argentina, which received its most recent IMF bailout just over a year ago, the country's debt/GDP ratio had risen to 60%, but importantly, a high proportion of this was held offshore. Also, inflation had risen to 50% and the peso had depreciated significantly. Consequently, the government had difficulty repaying its hard-currency debts and the IMF had to step in to help. Many IMF bailouts in the past have occurred under similar conditions, such as Russia in 1997 and Ghana in 2015. The issue is not necessarily a country's total indebtedness, but the extent to which it has borrowed in foreign currency. The government cannot print US dollars, euros or yen, and if its economy deteriorates, it can't borrow the currency to repay its existing debt, and a crisis develops.

So how does South Africa compare? While our current debt/GDP level, at around 60%, is in line with the levels of Argentina, Russia and Ghana before their IMF interventions, only around 10% of government debt is denominated in foreign currencies, and this debt has an average weighted maturity of 10 years. Additionally, our inflation rate is contained at around 4%. A further differentiator is the structure of our government bond market, where unlike many other emerging markets, bonds are issued at maturities out to 30 years, making refinancing risk very limited. In fact, South Africa's domestic bond market has the second-longest maturity profile in the world (after the UK), creating a structural strength in our financial market that sets us apart from many other emerging markets.

That is not to say that we shouldn't be alarmed by the current debt trajectory on which the South African government finds itself. It is a serious situation, particularly as we are being forced to spend more and more of the government's scarce budget on higher interest repayments. This is why it's vital that the government develop specific plans to control expenditure, reform indebted state-owned enterprises, enhance economic growth and limit any further expansion of the borrowing requirements. Measures to achieve these aims will hopefully form part of the February 2020 budget - the market and rating agencies are now looking to this for signs that a serious reform agenda is underway. ■

David joined Prudential in 2008 as Head of Fixed Income and was appointed as Chief Investment Officer in 2016. With 29 years of industry experience, David has worked in a range of senior roles within the fixed income space, both in South Africa and abroad. He holds a Bachelor of Science degree in Economics from the London School of Economics, a Bachelor of Science (Masters) degree in Economics from Birkbeck College and is an Associate of the Society of Investment Professionals.

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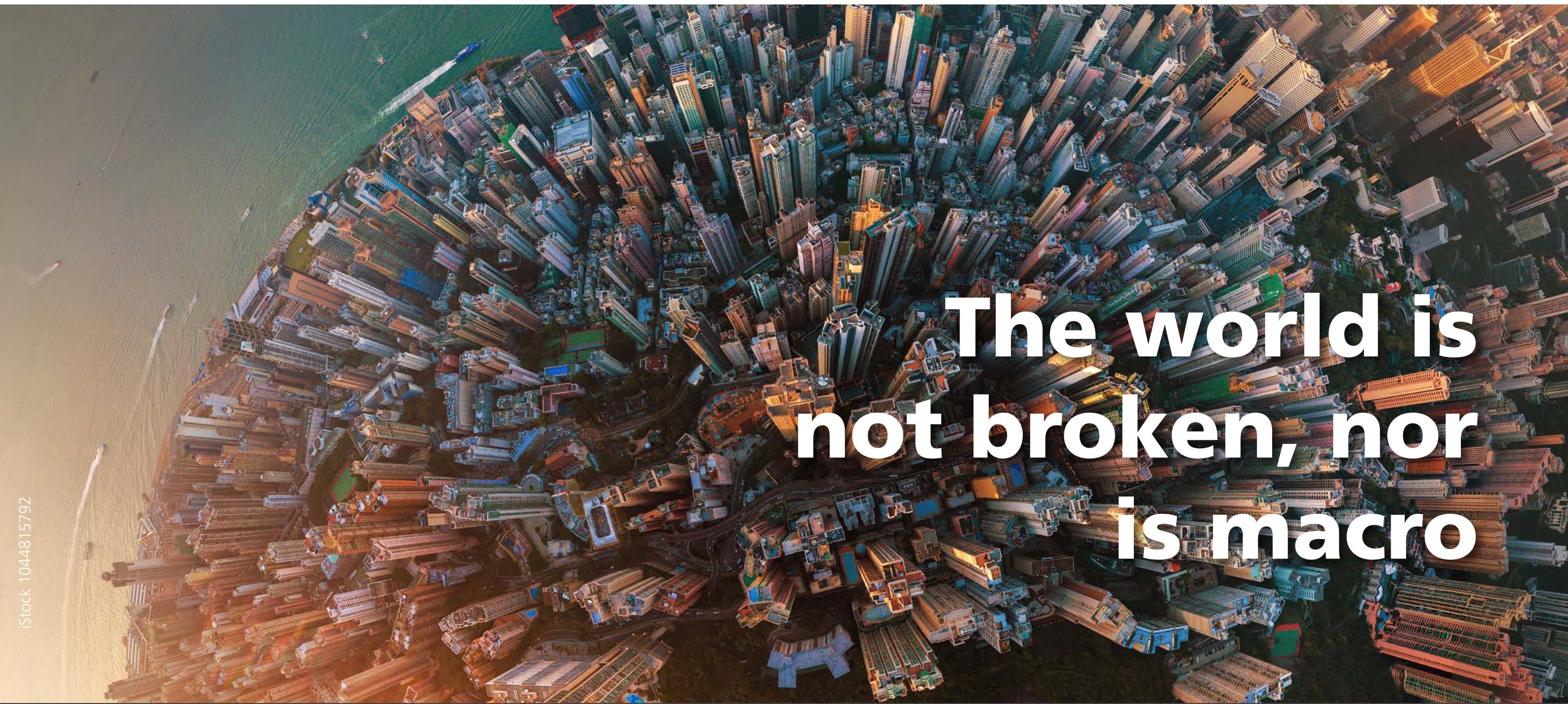

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The world is not broken, nor is macro

Dave Fishwick & Stuart Canning
PORTFOLIO MANAGERS AT M&G INVESTMENTS

KEY TAKE-AWAYS

- The strong returns delivered by both global equities and bonds in 2019 surprised many commentators given the generally negative environment that prevailed, sparking much speculation that macroeconomics and traditional market norms were "broken".
- Examined from a valuations perspective, however, initial investor expectations for 2019 were turned on their head for monetary policy and growth during the course of the year, leading to favourable conditions for both equities and bonds and a re-rating in global equity markets. This view explains 2019's good gains, outweighing any negative effects of weak earnings news or pessimistic growth outlooks.

Investors holding 'traditional' long-only multi asset portfolios have enjoyed a fantastic environment so far in 2019, with asset returns running contrary to highly pessimistic narratives about the state of the world.

Once again, many macro hedge funds and other hedge fund strategies have struggled by comparison, and are facing renewed challenges to justify their role in modern portfolios. Yet, an understanding of the true drivers behind this year's returns reveals that, far from invalidating them, market moves have only served to increase the importance of the role to be played by macro hedge funds.

Year to date 2019: strong returns and confused narratives

The year to date has profoundly shocked many expectations. In the face of mounting recession fears, trade wars, and what the IMF calls a 'synchronised slow down,' most major equity markets are up double digits. At the same time, developed market government bonds have also delivered strong positive returns not seen since 2014. This has been a source of profound confusion for those wanting to characterise the environment as either 'risk on' or 'risk off.'

The economic backdrop is far removed from where it was eighteen months ago. As recently as October last year, the key question seemed to be how high US rates could go, not how many more cuts the economy would need. Only slightly earlier in 2018, the growth narrative was one of 'synchronised expansion,' not late-cycle imminent recession.

No investor with any experience should be surprised to see economic beliefs confounded so dramatically. Such shocks are nothing new or unusual; they are the normal state of affairs, even if our brains refuse to believe it. What is more interesting is this confusion surrounding how assets have performed against this backdrop.

Correlated positive returns in equities and bonds so far this year run counter to the mental models that many of us have of how asset prices behave: the positive return on risk assets seems inconsistent with the pessimistic mood-music of data and commentary, and sudden shifts in 'value versus growth' or the outperformance of the US banking sector do not fit conventional narratives.

In keeping with much of the commentary since the financial crisis, such moves are seen as something that 'shouldn't happen,' a function of a world that is 'broken,' and a distorted financial system. There is often an underlying anger and frustration in many attempts to characterise what has been going on.

The role of rating

Such confusion is a manifestation of how the world is presented to us. Most of the investment commentary we see day-to-day on outlets like CNBC or Bloomberg has described short term price moves through the lens of either 'intensification' or 'lulls' in trade war fears, speeches by Central Bankers, or the President's tweets.

But these 'news-led' interpretations are incomplete at best. Very little commentary seeks to explain market moves interms of how assets are valued, and what it is that prompts the market en masse to re-rate or de-rate assets. Moreover, even when policy makers dominate the headlines, it is moves of 25 basis points here or there in policy rates or quantitative easing announcements that often gain the most attention, even as government bond yield moves of 100s of basis points are given less airtime.

In this journal last year ('Volatility is back, but this time it's different,' HFJ, April 2018) we sought to redress this imbalance in commentary. In that article we wrote about the central role played by asset valuations, and in particular the global risk free rate, which acts as a "correlating force" that can "create price shifts and volatility that are not a function of 'news' as such; but merely of changes in perceptions of risk, and how investors believe they should be compensated for it."

As it proved in both February and October 2018, it was rising rates in the US that drove markets, prompting equity losses. And by the end of that calendar year, many were surprised to find that few, if any, major asset classes had delivered a positive return.

However, following the 'risk off' episode in November and December of 2018, and over the course of 2019

Fig 1: 2019 Market dynamics set up 2019's strong returns

SOURCE: Datastream as at 13 November 2019

to date, it has been the collapse in global real rate structures, rather than rate increases, that has dominated.

This can be seen in figure 1; it shows the US two-year Treasury yield against the earnings yield for global equities. As US short rates rose in 2018, global equities de-rated (the earnings yield rising as the p/e fell). As short rates collapsed over the next twelve months, this was reversed.

It is this dynamic that accounts for the positive returns across assets we have seen so far this year. Moves in 2018 (both the shift in real rates, and the episode of myopic panic that dominated in December) served to increase the prospective returns on a range of assets, and equities in particular.

In 2019, it has been the re-rating of 'risk assets' against the backdrop of falling rates and the unwinding of that December episode that have driven positive returns, swamping any negative effects of weak earnings news or pessimistic growth outlooks.

Pivotal moment, part two

This dynamic has resulted in a highly fertile environment for plain vanilla

"Over the last twelve months, the favourable tailwind that existed prior to 2016 has been reasserted, 'granting a reprieve' to approaches which had struggled in the prior two years. "

long-only multi asset funds. Correlated gains across assets over longer periods have been accompanied by negative correlation when you have most needed it, with bonds acting like an insurance policy that also pays you handsomely over longer periods.

In fact, it is an environment that has been in place for much of the last thirty years and especially since the financial crisis. For all the talk of complicated strategies to manage volatility, mitigate tail risk, and generate 'uncorrelated' returns, it is the traditional mixes of equities and bonds that have delivered the types of return profile many have been crying out for.

And yet this environment is not a sustainable one. While the decline in global rates has gone far further than almost anyone would have expected, this does not change the fact that it is a finite game: all capital gains from fixed income assets are ultimately borrowed from the future, and the 'return tailwind' from ongoing rate declines can only go so far. Prospective sustainable returns are now close to zero.

This was a point we made in an article three years ago, the last time global rates were at similar levels to those prevailing today ("A Pivotal Moment?" HFJ, June 2016). In the period following that article we saw poor returns from bonds (from the middle of 2016 until the fourth quarter of 2018), correlated losses from long exposures to most asset classes in 2018, and, until very recently, disappointing returns from many macro hedge funds and other strategies which had sought to hide from volatility or equity correlation (see "The Wrong Type of Macro?" HFJ, July 2017).

Over the last twelve months, the favourable tailwind that existed prior to 2016 has been reasserted, 'granting a reprieve' to approaches which had struggled in the prior two years. However, this only takes us back to the playing field as it looked in 2016, with high realised returns only serving to increase the chances of low prospective returns.

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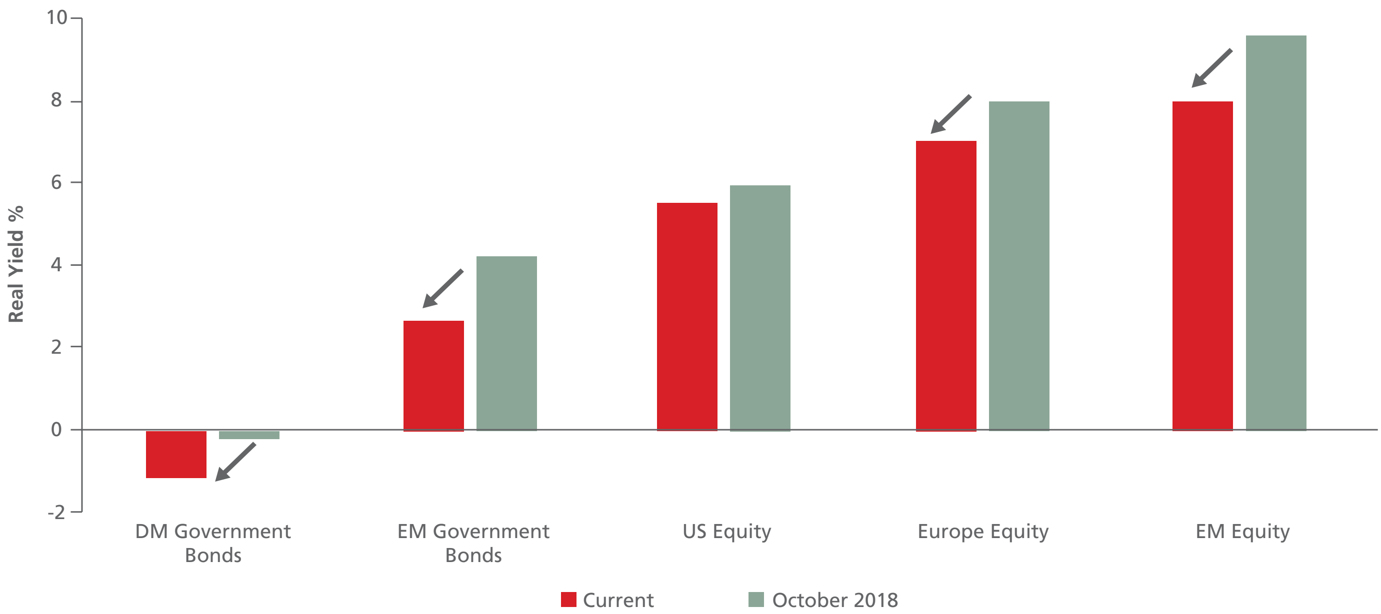
Fig 2: Major global assets re-rate from Oct 2018 onwards



DM Government Bonds = mean 10Y real yield of US, UK, Japan, Germany, Canada and Australia.
EM Government Bonds = mean 10Y real yield of S.Africa, Mexico, Brazil, India, Indonesia and Russia. Equity earnings yields using MSCI indices.

SOURCE: DataStream, as at 13 November 2019 and 31 October 2018.

Many acknowledge this, and much has been written this year concerning the 'death of 60/40 funds,' often citing the low prospective returns on bonds, their diminishing diversification properties, and the greater volatility of important areas of the fixed income market.

This is not to say that we should expect a reversal of fortunes imminently – the fact that such arguments are so widespread is probably reason enough to be sceptical – yet it is hard to argue that bond valuations suggest anything other than far lower returns, even in supportive environments, than those many of us have become used to.

Is cash your only defensive asset?

The re-rating of major financial assets since October 2018 can be seen in Figure 2 which shows the real yields (using consensus long term inflation expectations) on selected 10-Year government bonds, and the earnings yields on the MSCI indices for the US, Europe ex-UK, and emerging markets.

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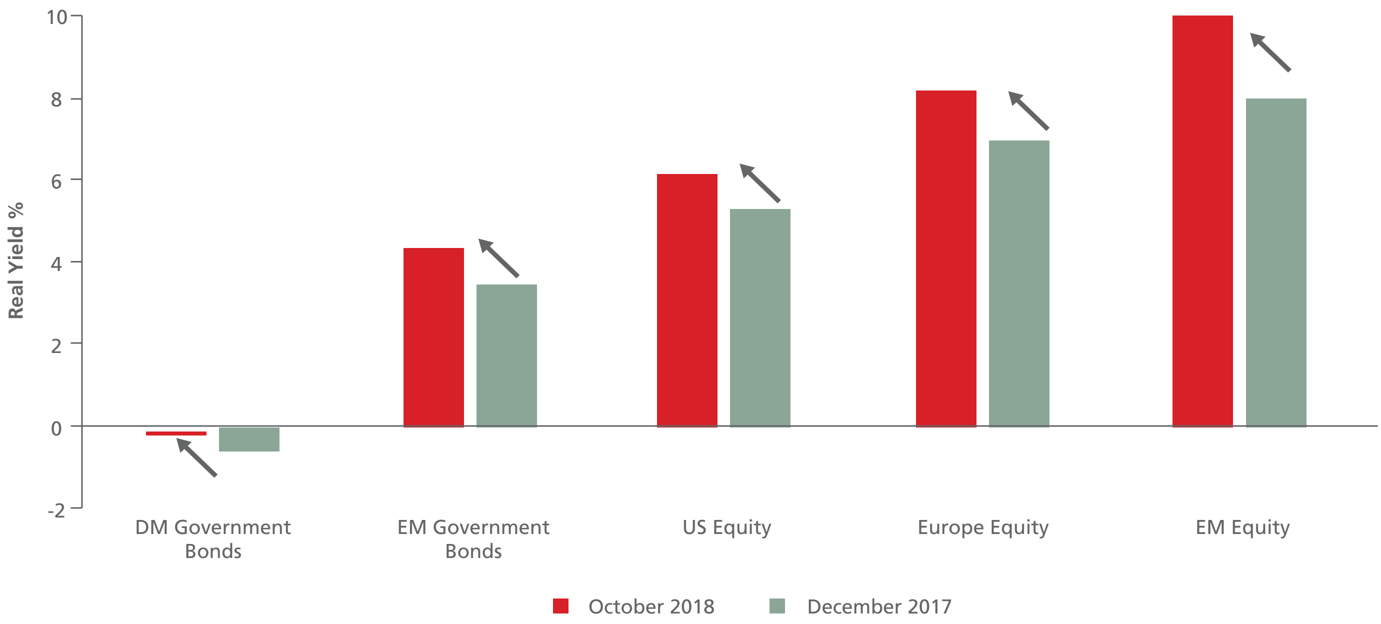
Fig 3: Major global assets de-rate from Dec 2017 to Oct 2018



DM Government Bonds = mean 10Y real yield of US, UK, Japan, Germany, Canada and Australia.
EM Government Bonds = mean 10Y real yield of S.Africa, Mexico, Brazil, India, Indonesia and Russia. Equity earnings yields using MSCI indices

SOURCE: DataStream, as at 31 October 2018 and 31 December 2017.

As rate expectations have declined, so conventional value metrics have become less attractive almost everywhere.

This suggests not only a greater likelihood of worse returns in the future, but also vulnerability to reversal. Compare figure 2 with the shift between the end of December 2017 and October 2018 (figure 3) where the dynamic is reversed.

In this rising rate environment, it was possible to generate positive returns in equity markets that grew their earnings (most notably in parts of the US), but otherwise there was nowhere to hide for long-only investors. Traditional assets held for capital preservation failed to deliver. In emerging markets, not only did assets deliver negative returns but currencies also weakened sharply.

Approaches without significant flexibility were left with cash as the only option to preserve capital.

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It is in just such phases that those very hedge fund strategies that have been criticised for failing to keep up with global equity markets, or even traditional balanced funds, have the flexibility to deliver positive returns, whether by shorting, targeted exposures, or dynamic market timing. For others seeking the 'holy grail' of high returns with low volatility and low correlation to growth assets there are far fewer options. Today, we appear to be at a similar juncture.

"For others seeking the 'holy grail' of high returns with low volatility and low correlation to growth assets there are far fewer options."

Does this mean that the world is 'broken?'

For those who view global financial markets as rigged by Central Banks, this is a troubling situation. And yet, for all the conspiracy theories it is hard to quarrel with permanently lower rate expectations from an economic standpoint. The inflation that many thought quantitative easing would unleash has yet to transpire, to the extent that few admit to having ever made the argument. In fact, the economic system has been one in which no matter what you throw at it, whether it be commodity price booms in the early 2000s or ultra-easy monetary policy, aggregate outcomes have been benign.

From this perspective lower bond yields do not seem inappropriate and the only real distortion is in negative policy rates, the effects of which are now being challenged by academics, policy makers, and politicians. At the same time, it is no contradiction to say that, while lower rates than prevailed in the 1970s to 90s are justified, it can still be the case that prospective returns to bonds are low and vulnerable to deeply negative outcomes, just as they were in 2016.

We should also be wary of believing that a low rate environment is synonymous with weak earnings growth. Many have conflated lower rates with a secular stagnation thesis, but this can be a dangerous assumption. While we cannot know the counterfactual, it has been the case that very low rates can run side-by-side with strong profits growth, as we have seen in the US. Profits growth can allow equity returns to be positive even against de-rating caused by rising rate expectations.

So long, long only

Once again markets appear to be at a critical juncture. A key difference between the landscape today and that of summer 2016 however, is that many areas of developed equity markets are now 'expensive' or fully valued. Whereas the post 2016 environment allowed for returns if one was willing to simply tolerate the volatility that comes with risk assets, it seems more likely that the flexibility to short, and a high degree of selectivity will be more important than it has been for some time.

As macro investors, we will seek to stay true to our approach of the last twenty years: acknowledging that the world is a profoundly surprising place, and from this position of humility seeking to capture sustained trends in asset class returns. Doing so will require more than simply maintaining a static bullish or bearish view, a passive long exposure to a range of assets, or pandering to the idea that high returns can always be generated with low volatility and low correlation to growth dynamics. ■

David Fishwick is the Head of Macro and Equities Investment at M&G Investments. With more than 30 years of investment management experience, David joined M&G in 1987 as a European economist and subsequently served in a number of senior roles. His qualifications include a Bachelor of Science degree in Economics from Brunel University, London.

Stuart Canning joined M&G Investments in 2005 and is a Research Analyst in the Multi Asset team. With 15 years of investment management experience, Stuart holds a Bachelor of Arts degree in English and History from the University of York.

iStock 1133579537

Can you bet on South African government bonds now?

Roshen Harry
PORTFOLIO MANAGER

KEY TAKE-AWAYS

- The SA bond market is facing the threat of a downgrade to sub-investment grade level by Moody's, which would expel our bonds from the World Government Bond Index and prompt sales by index-trackers and investors unable to hold sub-investment grade bonds.
- While there are different views of the bond market reaction should this happen, at Prudential we believe this is already largely priced into current bond yields, and that therefore the risk to investors is less than many believe. Our most likely scenario is for some initial strong selling followed quickly by buying by investors wanting the attractive yields on offer. We believe the yields now on offer are attractive, adequately compensating investors for this risk already.

Going into 2020, South Africa faces weak growth, persistent fiscal concerns and a possible ratings downgrade. In addition, December's bouts of power cuts have weighed on market and consumer confidence and raised the chances of the economy moving into a recession. The Medium-Term Budget Policy Statement (MTBPS) delivered in October 2019 forecasts the public debt-to-GDP ratio to reach a worryingly high 71.3% in 2022/23, with no debt consolidation in sight – news which was not well received by the market. Some assert that the MTBPS was used as a tool to signal to government the country's urgent need to embark on its reform agenda, which would boost much-needed growth. This, in turn, would increase revenue collections over time and pave the way for an improvement in public finances, ultimately reducing the cost of capital. Whatever your view, it is clear the fiscal position has added to the basket of risks which have weighed on the local bond market, given that any further fiscal blow-outs would result in the government having to issue more debt.

Entering the new year against this backdrop, one factor that will be hanging over our government bond market is the increased risk of a downgrade by Moody's Investor Services (Moody's) of our sovereign investment grade rating from Baa3 to a sub-investment grade rating. This downgrade would result in the automatic expulsion of South African government bonds from the World Government Bond Index (WGBI). What would be the effects of this move?

Possible impacts of exclusion from WGBI

One view is that this exclusion will cause foreign investors to sell between US$3 billion and $10 billion of our government bonds. With these bonds needing to find a home, bond yields would, as a result, increase meaningfully.

Another view suggests that the WGBI investor exposure to South African bonds is only moderate, and so an increase in yields from a WGBI exclusion would be only temporary, as non-benchmarked investors and local fund managers would snap up the bonds as they became attractive. A third view is that the downgrade to sub-investment grade could ease market uncertainty, which could result in the stabilisation of government bond yields.

As is the norm in any well-functioning market, there are clearly a range of differing views on this topic. By and large, however, investors appear to be generally pessimistic with respect to

South Africa's growth prospects and fiscal health in the medium term. That pessimism, we think, is largely reflected in the elevated level of government bond yields in the local market. This article will try to provide some reasons as to why we at Prudential think South African (SA) government bonds offer value for investors at their current yields.

Prudential's view on SA government bonds

Considering all of the negative factors above, our view is that much of the prevailing pessimistic sentiment is already priced into government bonds, and therefore any potential bond market sell-off will not be as severe as many anticipate – after all, markets are forward looking. Consequently, we consider these assets to be cheaply valued, offering attractive returns in the medium term (over three to five years). Below I discuss inflation as an important factor, as well as three key measures which support our view (historic real bond yields, relative credit default swap spreads and relative real bond yields), keeping in mind that this is not an exhaustive list. These measures do, however, form part of our investment decision-making process.

Inflation

When looking at bond yields it is important to consider inflation, given that it erodes the purchasing power of the returns investors receive over time. The higher a country's inflation rate is expected to be (inflation expectation), the higher the yield an investor should require to compensate for this erosion of purchasing power. The yield investors receive after adjusting for inflation is called the "real" yield. Currently, SA inflation outcomes show subdued inflationary pressures, much like most of the developed world, at 4% y/y in December 2019, well below the South African Reserve Bank's mid-point inflation target of 4.5%. Meanwhile, according to the Bureau for Economic Research (BER)'s fourth quarter 2019 survey, expectations for headline inflation are trending downwards towards the SARB's mid-point target, now at 4.5% for 2019 (from 4.6% in the previous quarter). Inflation expectations for 2020 and 2021 have continued to ease gradually and are at 4.8% and 5.0%, respectively, the lowest levels since 2007, and five-year-ahead inflation expectations have also declined to 4.9% from 5.0%. Two years ago the latter was closer to 6%, at the upper end of the SARB's 3-6% inflation band.

High real bond yields

Looking at absolute yield levels as of 16 January 2020, long-dated government bonds as measured by the 10- and 20-year bonds are yielding about 9.0% and 10.10% respectively, at the upper end of their trading range over the past four years. SA's subdued inflation gives investors who buy long-dated bonds the ability to earn attractive real yields of about 4.5% to 5.6% in the 10- to 20-year tenors, assuming inflation is anchored at 4.5% over the term of the bonds. Using the Bloomberg consensus headline inflation forecasts for 2020 and 2021 of 4.7 and 4.8% respectively, inflation is expected to be well behaved in the near term. Alternatively, using BER's five-year inflation survey, the longer- term inflation outlook has also moderated. Remember that investors are still assuming inflation risk, in believing that the SARB will continue to exercise its mandate successfully and not lose its credibility by letting inflation run back to the upper end of its inflation target band and beyond. Should inflation return to the 6% level, the real return on long-dated bonds would fall to 3% to 4%, but we would still consider to be an attractive return proposition.

Graph 1 (in the left box) plots the yield-to-maturity of our 20-year government bonds since the year 2000 alongside SA's expected annual inflation rate. The right box illustrates real yield, which is the difference between the bond yield and SA inflation. They clearly highlight that real yields are at elevated levels compared to the observation period. They are also well above our view of their long-run fair value (which is around 2.5%). Hence this supports our conviction that long-dated government bonds offer attractive returns over the medium term.

Elevated relative credit default swap spreads

Another way to measure how the market is valuing South African debt is to compare the country's credit default swap (CDS) spread versus other countries. A CDS can be thought of as an insurance policy that can be bought against a default or other credit event by the debtor. They are essentially derivative contracts that transfer credit exposure between counterparties. The higher a country's credit rating, the lower the CDS spread (since there is less risk involved in holding their debt) and vice versa.

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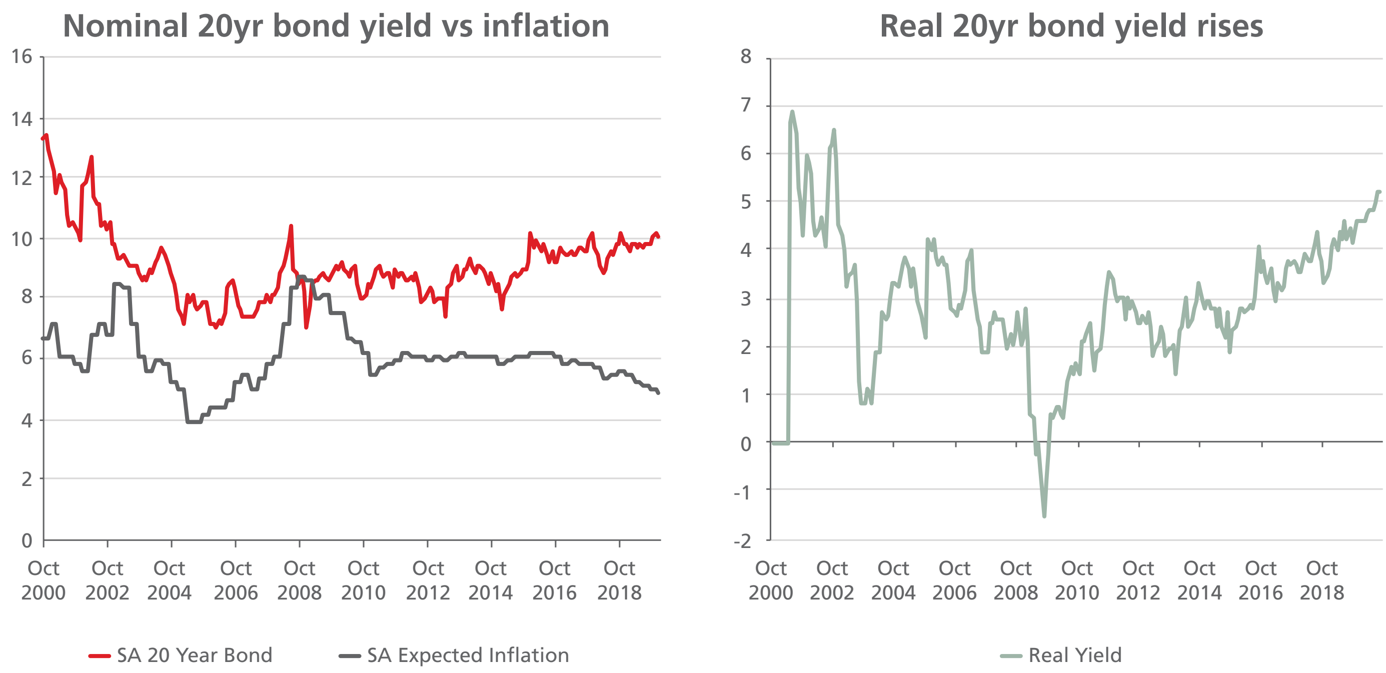
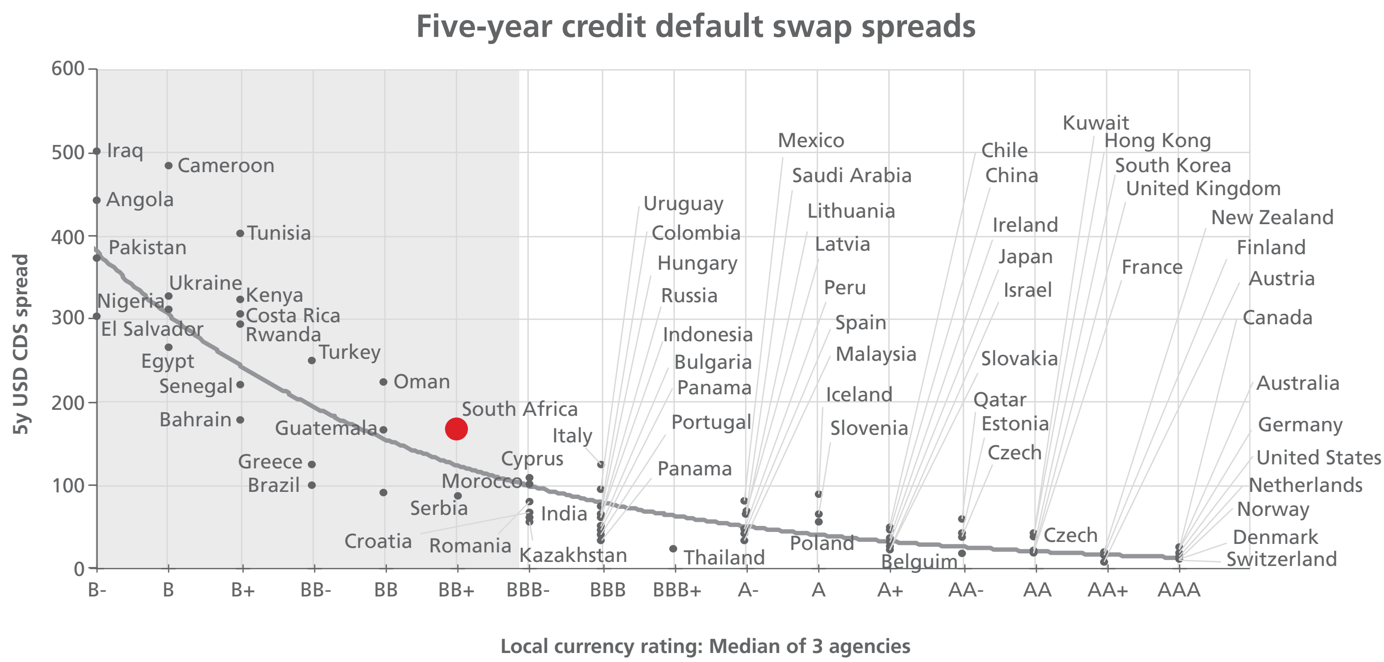
Graph 1: Attractive real bond returns on offer



SOURCE: IRESS, Bloomberg 31 December 2019

Graph 2: SA already priced at sub-investment grade by market



SOURCE: S&P, Fitch, Moody's, Bloomberg 16 January 2019

Graph 2 shows the five-year CDS spreads of investment and sub-investment grade countries, with the latter plotted in the shaded area. South Africa's CDS spreads are already trading at about 170 basis points (1.7%, as shown by the red dot), comparable to countries that have sub-investment grade ratings of BB. Equally, countries rated in the lower range of investment grade (BBB-) are trading at CDS spreads of 75 to 125 basis points (0.75% to 1.25%), lower than South Africa. This clearly shows the market is already pricing South African debt at sub-investment grade.

Based on this observation, we could infer that should Moody's downgrade SA to sub-investment grade, the odds of further extended weakness in our government bond market are rather slim. There could be initial knee-jerk selling following the news of a downgrade, but we believe this could evaporate rather quickly as investors see a good buying opportunity.

Of course this scenario bars any further deterioration in the national fiscus that might occur this year, should projected debt levels continue to rise more sharply than expected or the

"Equally, countries rated in the lower range of investment grade (BBB-) are trading at CDS spreads of 75 to 125 basis points (0.75% to 1.25%), lower than South Africa."

economic growth outlook worsen even more. This could then cause a shift in market expectations toward further downgrades to come, and more bond market weakness as the government would be forced to borrow more. Hence the urgent requirement for fiscal responsibility and growth-enhancing reforms.

High relative real bond yields

Finally, Graph 3 compares 10-year real bond yields across some of South Africa's peer countries, where our government bonds undeniably stand out as offering very attractive real yields. Using the S&P long-term local currency rating, SA has a higher credit rating than both Brazil and Turkey, and can offer highly developed, deep and liquid financial markets along with strong macroeconomic institutions that are viewed as credible by international institutions; yet it offers higher real yields to investors. Equally, the graph shows the unattractive (negative)

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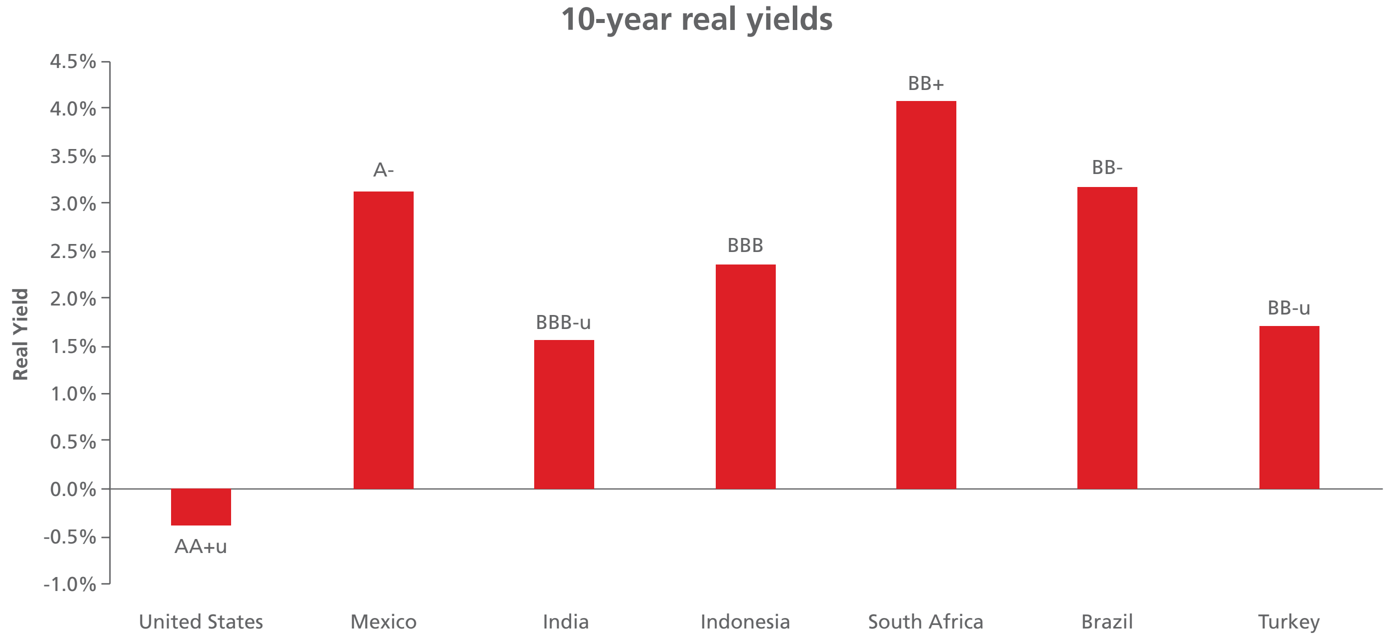
Graph 3: SA real bond yields higher than most countries'



SOURCE: Bloomberg, Consensus Economics 20 January 2020

real yield on 10-year US Treasuries, indicating their poor return prospects. Real returns are even more negative on most European government bonds. Although SA's long-dated bonds could weaken further, if an investor is willing to ride out the volatility over the medium term, prospective returns are very likely to be attractive given the starting yield.

Overweight SA government bonds

In this article I have highlighted some of the primary risks associated with our government bonds that could cause investors to avoid them. Yet rarely do we find that bargains are to be had in financial markets when the news flow is positive and market confidence is high. In a Bank of America Securities SA Fund Manager review, the majority of fund managers considered the South African 10- year government bond to be undervalued, and more managers were bullish on SA bonds on a 12-month view than bearish. Yet only 25% would buy them at current levels and the vast majority would only be buyers at cheaper levels. This indicates excessive pessimism toward our assets. Yet even though these assets

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can become cheaper, we do not have much faith in the ability of investors (including ourselves) to successfully time the markets consistently – in this case, to time the bottom of the market. Hence, for valuation-based investors like ourselves we consider the investment proposition to be an attractive one.

Investing is not a sure thing, and no position is without risk; this is why we at Prudential have a risk-based approach to investing. Our approach is to scale into positions over time, gradually building our exposure as assets become cheaper. Currently we are constructive on long-dated SA government bonds in our portfolios, with the capacity to invest further capital into these assets should yields rise even further.

At the start of 2020 we are overweight longer-dated South African government bonds in our multi-asset unit trusts, including the **Prudential Balanced Fund**, **Prudential Inflation Plus Fund** and **Prudential Enhanced Income Fund**. We find that, although these assets do certainly face some challenges in the coming year – including a possible credit rating downgrade – their current real yields adequately compensate investors for assuming the risks of owning them. ■

Roshen joined Prudential in 2006 and is the joint-Portfolio Manager of several Prudential funds. With 19 years' industry experience, Roshen completed his articles at Deloitte & Touche before joining Rand Merchant Bank in their Risk and Compliance division. He holds a Bachelor of Commerce degree and a Post Graduate Diploma in Accounting, both from Rhodes University. He is a qualified CA (SA) as well as a CFA charterholder.

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KEY TAKE-AWAYS

- Asset managers have certain rules and business structures in place to ensure they avoid conflicts of interest with their clients; for example, never trading with their own clients, and using independent brokers for trading assets rather than associated brokers (those within the same group). Otherwise there would be opportunities for asset managers to overcharge, to trade at unfair prices, and to leave clients with unfavourable assets at a loss, among other conflicts of interest.

- There was a recent instance in SA in which an asset manager who traded with their client (without the client's knowledge) through an associated broker lost R349 million in the client's pension fund investments – a very unfortunate case that would never have happened should the appropriate structures have been in place.

- In safeguarding clients' assets, humans can stumble in their everyday work, which is why top asset managers like Prudential have set up strict rules and structures in their own businesses which work to help ensure our actions are free from conflict of interest across the entire value chain.

Kerry joined Prudential in 2010 as Head of Risk and Compliance. With 24 years' industry experience, she has worked in a range of senior roles within Compliance and Risk Management, including Head of Compliance at Old Mutual Investment Group. Kerry holds Bachelor of Arts and Bachelor of Laws degrees from the University of KwaZulu-Natal, as well as a Master of Laws degree (Distinction) from the University of Cape Town.

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iStock 458591871

The battle for "bling" could be heating up

Kaitlin Byrne
PORTFOLIO MANAGER

KEY TAKE-AWAYS

- The combination of Tiffany and LVMH could create even stronger competition for Richemont and other top global jewellery brands, given the two companies' complementary market presence.
- The merged LVMH-Tiffany group will overtake the more successful Richemont in size, and key will be whether LVMH is able to turn around Tiffany's slumping revenues.

Towards the end of 2019, the world's high-end jewellery investors were given a reason to be excited about the coming year with the announcement of the proposed buyout of Tiffany & Co, the US's number-one jewellery brand, by European luxury group LVMH. What kind of shake-up could materialise in this exclusive market of historic brands, and what innovations could it spur in the competition for the wallets of the rich and famous? Here we take a look at what the transaction could mean for the global jewellery market and for investors in LVMH and Richemont, one of South Africa's larger listed global corporates and a keen competitor of LVMH and Tiffany.

As equity analysts, we are able to have a glimpse into the world of branded jewellery because three of the globe's most popular jewellery brands are all currently owned by publicly listed companies – Cartier (owned by Richemont), and Tiffany and Bvlgari (owned by LVMH). Apart from these three large brands and a few other big branded names, the jewellery market globally is highly fragmented. This market includes engagement rings, high-end jewellery and jewellery collections along a wide range of price points, and usually excludes luxury watches. However, here we include them as key parts of the businesses.

Richemont has pulled ahead in recent years

Richemont, which owns Cartier (jewellery and watches) and Van Cleef & Arpels within its jewellery Maison, is a good example of a company which has made a major success of its jewellery brands and managed to continue to grow these year after year – across revenue and operating profits. In fact, they have managed to expand the margins in their jewellery division from 20% to 30%. And because this figure includes Cartier watches at a lower margin than jewellery, the margin they earn from jewellery alone is even higher.

Yet Richemont's overall success has masked some difficult periods. The group used to be more famously known for its numerous luxury watch brands including Cartier, IWC and Panerai, which, along with the rest of the global watch market, experienced a major expansion until 2013. At this point, the Chinese government clamped down on "gifting" in the public sector, resulting in pressure on watch sales. After years of high growth, the sudden slowdown in sales resulted in an oversupply in the market that is taking years to correct. As investors focused on the declining watch margins within Richemont and the continuous buybacks of stock from wholesalers to reduce the excess watch stocks, global jewellery sales continued to rise. And because jewellery has margins nearly double those of watches, jewellery became by far the largest source of the group's operating profit.

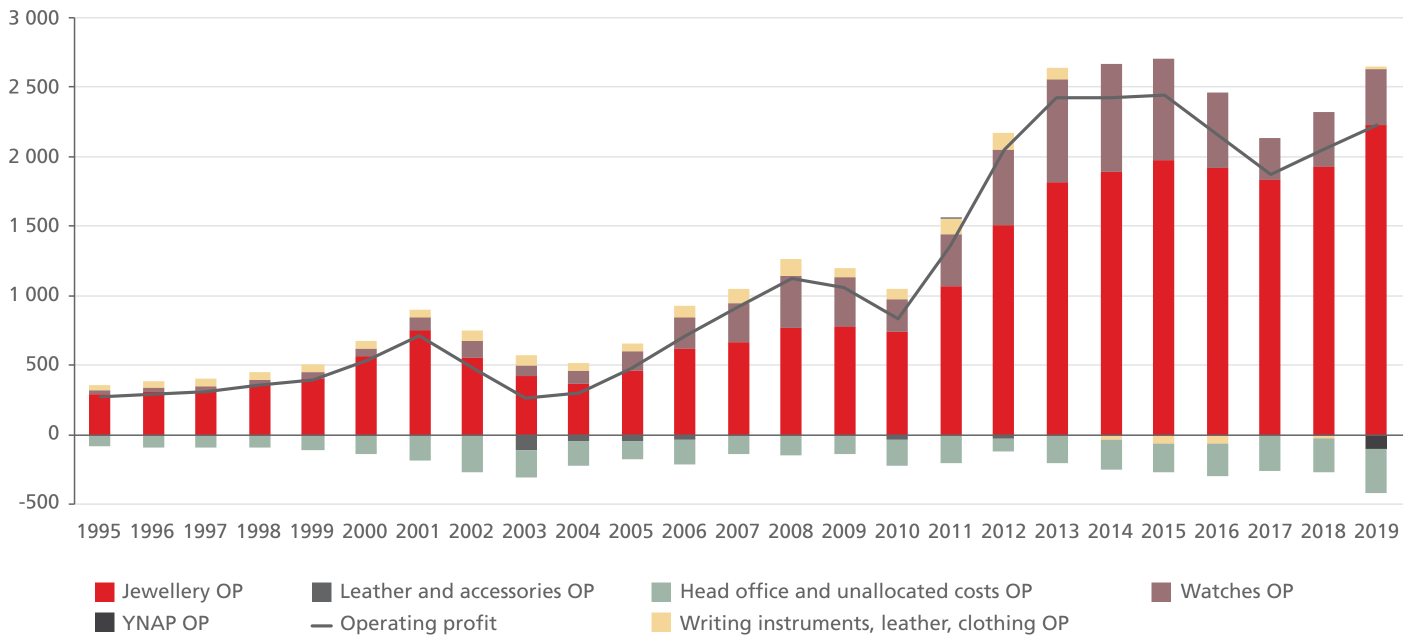
Graph 1 shows this change in the composition of Richemont's operating profit over nearly 25 years, with its jewellery business now accounting for the majority of the value of the company. At the same time, Graph 3 details the strong revenue growth and high margins Richemont has generated from its jewellery business relative to LVMH in recent years.

Prudential has held an overweight position in Richemont over the last few years as we felt the value of its strong jewellery business and brands was not fully appreciated by the market, as concerns around the declining watch business masked the compounding growth within the jewellery business. Prudential's portfolios have benefitted from this overweight position, as the share delivered a 20.1% return in 2019.

Has LVMH simply been lucky?

LVMH, which is predominantly known for its leather bags and clothing (Louis Vuitton, Christian Dior) as well as its champagne (Moet & Chandon) and cognac (Hennessy), has been selling watches and jewellery since the mid-1990s, but watches and jewellery make up only 9% of LVMH's total revenue.

Graph 1: Richemont operating profit* shows strong growth
(Euro millions)



*Split of Richemont's operating profit between the different divisions. Richemont includes Cartier Watches within its jewellery division, therefore pure jewellery profit excluding all watches is slightly less than shown above.

SOURCE: Prudential & Company reports

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Investor interest in LVMH's jewellery really only gained traction post its acquisition of Bvlgari in 2011, when it demonstrated its ability to double Bulgari's revenue and expand margins from an estimated 9% to 24%. The key question is whether LVMH really has found the secret to creating a highly profitable jewellery business, or whether it was exceptionally lucky in its timing of the acquisition, which followed on the heels of the Global Financial Crisis (GFC) -- hence Bvlgari's margins had plummeted and then benefitted from the good growth in the jewellery market post 2011.

The answer is probably somewhere in between the two. We would suggest that the company's ability to make a success of Tiffany & Co, their largest acquisition to date, will get us closer to the real answer. LVMH announced the planned US$16.9 billion purchase (some R236 billion) in late 2019, and is acquiring Tiffany at margins that are fairly close to their long-term average.

"Tiffany's revenue growth has been pedestrian, and stifled by shareholders who have focused on cash flows"

Tiffany's revenue growth has been pedestrian, and stifled by shareholders who have focused on cash flows. This has restricted its ability to invest for long-term growth.

Following the news of the acquisition, there was mixed reaction and speculation by the market as to why LVMH would go after a company such as Tiffany, especially given its high proportion of engagement jewellery (almost one-third of its product mix), which is considered to be a fairly low-growth market segment. Equally, Tiffany does not craft "distinguishable" jewellery pieces, a key selling point which rivals Bvlgari and Cartier have kept core to their brands.

Table 1: Global iconic jewellery houses

Jewellery Brand	Parent	Founded
Cartier	Richemont	1847
Van Cleef & Arpels	Richemont	1906
Buccellati	Richemont	1919
Bvlgari	LVMH	1884
Chaumet	LVMH	1780
Fred	LVMH	1936
Tiffany	Tiffany & Co	1837

SOURCE: Company Reports

What's the deal?

As detailed in Table 2, LVMH has made an all-cash offer to acquire Tiffany for a total value of $16.9bn and an equity value of $16.2bn, equivalent to US$135 per share, a 50% premium to the share price at which Tiffany was trading prior to the offer. Based on Tiffany's 2018 results, the multiple paid is a 16.6x EV/EBITDA, and a 3.8x EV/Sales, which is comparable to its previous Bvlgari and Christian Dior acquisitions on an EV/Sales basis, but seemingly cheaper than their Bvlgari acquisition on an EV/EBITDA basis. However, the latter is due to the depressed margins in Bvlgari at the time of that acquisition compared to Tiffany's more normalised margins now.

The deal will take LVMH from a net debt/EBITDA of 0.5x to around 1.6x, which is still a fairly low debt level, posing little financial risk to the company. Over the past few years, Tiffany has generated between US$500-700 million free cash flow (FCF) every year after all capital investments for a 3.5% FCF yield. This indicates that for LVMH to generate a decent return on their investment, they will need to ensure that Tiffany returns to revenue growth and margins can be improved further, to realise at least 5% growth per annum in order to get to an 8.5% return (3.5% free cash flow yield + 5% cash flow growth).

Given the number of successful deals that LVMH has done over the years, especially its turnaround of Bvlgari, the market is clearly optimistic that LVMH can work its magic on Tiffany in the same way. The share price of Tiffany has shot up some 46% since the deal was announced, while LVMH's share price has gained 16%. The transaction is expected to close in mid-2020.

Table 2: Recent LVMH Deal Multiples

Acquisition	Enterprise Value	EV/ EBITDA	EV/Sales	Year Acquired
Tiffany & Co	$16.9bn	16.6x	3.8x	2020
Bvlgari	$5.2bn	22x	3.6x	2011
Christian Dior Couture (Leather & fashion)	$7bn	15.6x	3.5x	2017

SOURCE: Prudential and company reports

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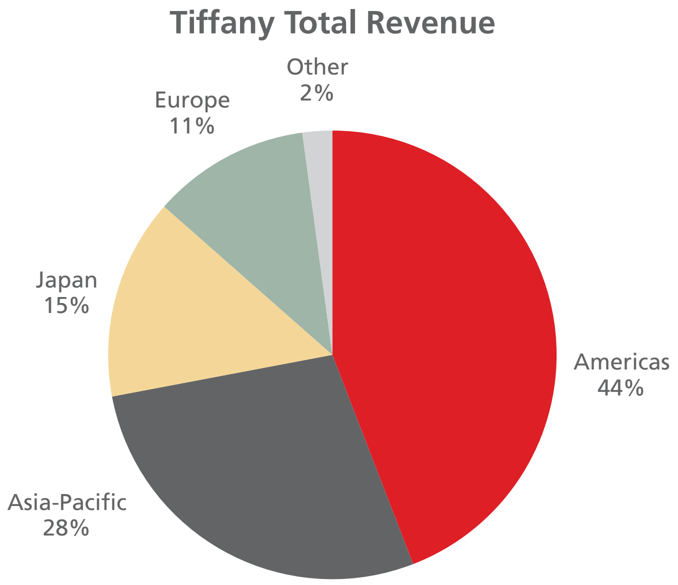
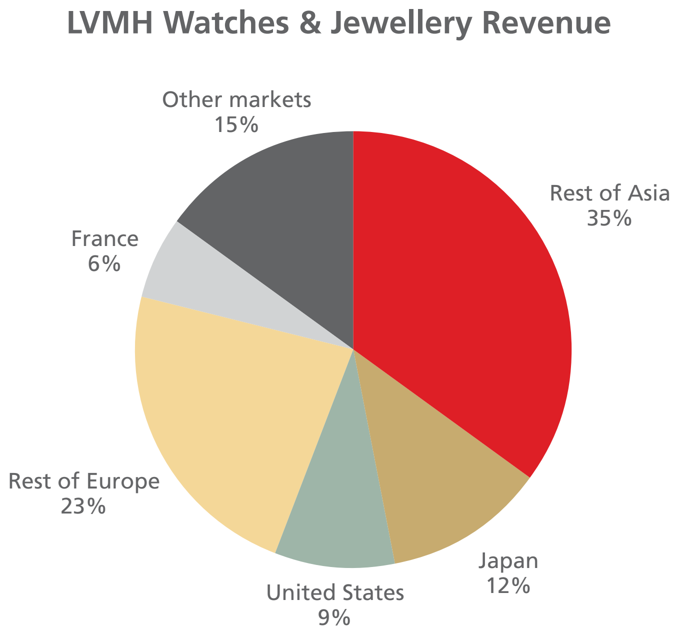
Graph 2: Tiffany and LVMH revenue split by geography





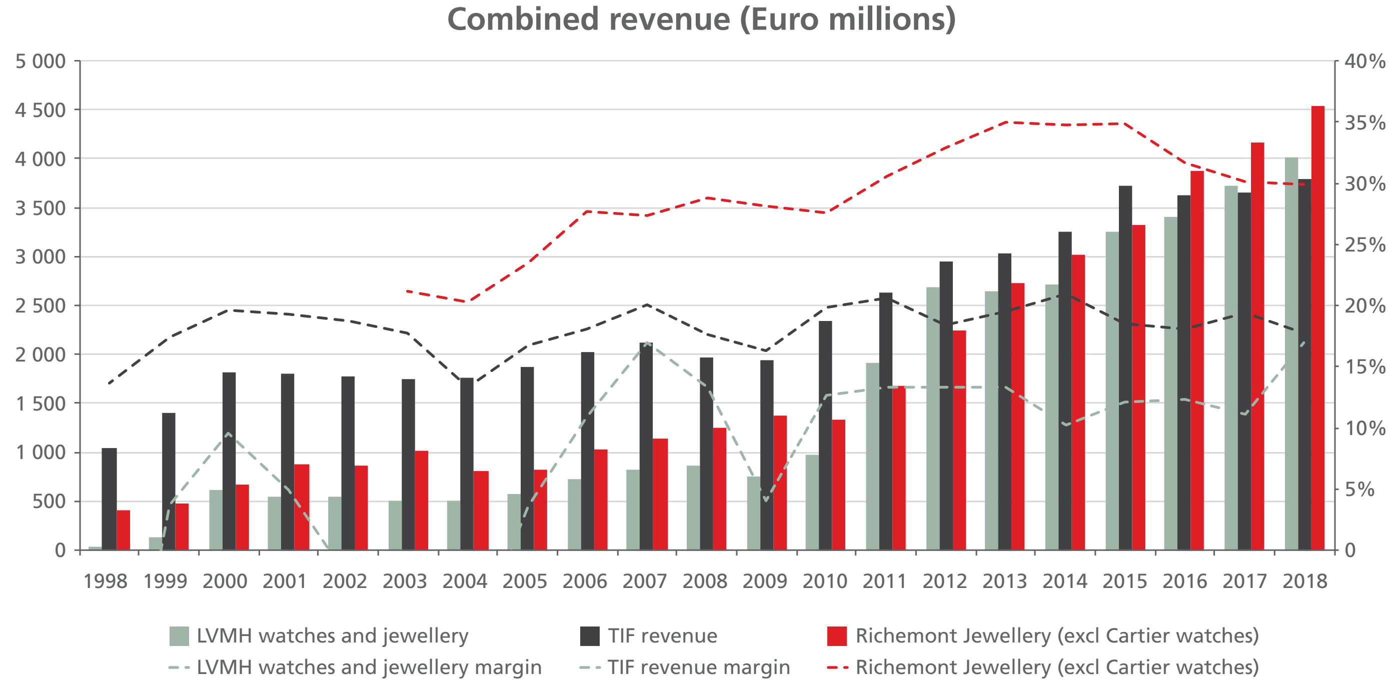
SOURCE: Prudential & Refinitiv, LVMH website

Why would LVMH spend such a huge sum to acquire Tiffany rather than expanding their own jewellery lines organically? First, LVMH has always acquired brands and is essentially a conglomerate of numerous acquisitions. The brands they have purchased in the past, including Tiffany, were in fact founded a few hundred years ago -- this type of history simply cannot be replicated. Just for interest, we have listed the founding dates of some of the world's best known jewellery brands in Table 1. Maintaining or improving on the brands' strength is the number-one priority for luxury goods companies. Although having attractive jewellery designs is also important, they can be easily replicated, and new designs can be introduced by competitors. Meanwhile, a strong brand name and what that brand represents keeps consumers from switching out of the brand, creating a high barrier to entry.

Tiffany: An iconic US brand

Tiffany has always had an exceptionally strong brand in the US, being the country's number-one preferred jewellery brand. The company was established in 1837 by Charles Lewis Tiffany and is known for its diamond rings and iconic Blue Box, which has been used since Tiffany first started

Graph 3: Richemont overtakes LVMH in most key financial measures



SOURCE: Prudential and company reports

selling its diamond rings in 1886. Over the past few years their presence and brand image in China has been growing strongly, elevating it now to the number-two preferred brand in China after Cartier, according to an HSBC survey. This is Tiffany's largest attraction for LVMH -- its strong brand name and history.

The second attractive attribute that Tiffany has is its broad retail footprint. It has 321 company-operated stores globally, 93 of which are in the United States, its home market, and 90 in Asia Pacific, the fastest-growing region. Over the past five years, its store count in the US has remained largely stable, while its Asia-Pacific numbers have grown by 23%, indicating Tiffany's strong focus on the higher-growth Asian market. LVMH has an even bigger reach, with 428 watch and jewellery stores globally. Tiffany management believes that being within the LVMH stable will allow them to leverage off LVMH's expertise in the very important Asian market. In the same way, LVMH can leverage off Tiffany's experience in the American market. As shown in Graph 2, the United States accounts for only 9% of LVMH's jewellery sales, compared to Tiffany's 44% in the Americas region.

Turning around subdued revenue growth

One big challenge for LVMH as a new parent company will be tackling Tiffany's sluggish revenue growth over the last five years, which has allowed Richemont to overtake it, as shown in Graph 3. In 2017 Tiffany tried to revive growth itself through a transformation strategy that included renewing its product offerings and in-store presentations; strengthening its brand message and committing to higher investment spending. In not resisting the buyout, the company is tacitly admitting that it has not achieved its goals, and is therefore leaving it to LVMH to work its magic.

LVMH's acquisition of Tiffany, currently a standalone listed company, will result in Tiffany's financial results being reported within the larger LVMH group, therefore allowing LVMH to increase investment into the brand, but without the same degree of investor scrutiny or publicly available financial information as currently.

Within LVMH, jewellery and watch sales currently make up 9% of LVMH's revenue, but once the transaction is completed, this will almost double in euro terms to 16% of group revenue. Once combined, LVMH's jewellery division revenue will exceed that of Richemont.

Looking ahead, Richemont will be closely watching developments at the bigger, combined LVMH-Tiffany. The threat posed to Richemont will be significant if LVMH can return Tiffany to growth and, in so doing, take market share from Richemont, after years of market share loss by Tiffany. The increasingly competitive environment may in turn prompt Richemont to boost investment in its own brands. Consumers are likely to be the real winners of any heightened rivalry, given that it could very well spur the creation of many new and wonderous pieces of jewellery to ignite the consumer imagination and add bling to any occasion. ■

Kaitlin joined Prudential in 2015 as an Equity Analyst and was appointed as joint-Portfolio Manager of the Prudential Dividend Maximiser Fund in January 2020. Prior to joining Prudential, Kaitlin completed her articles at Ernst & Young, where she was responsible for auditing companies in the Finance, Gaming and Leisure, Real Estate and Manufacturing sectors. With five years' industry experience, Kaitlin holds a Bachelor of Accountancy degree from Stellenbosch University and is a qualified CA (SA) as well as a CFA charterholder.

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Is SA corporate credit too expensive?

Gareth Bern
HEAD OF FIXED INCOME

KEY TAKE-AWAYS

- Some investors are arguing that SA's corporate credit – particularly floating-rate notes – has become too expensive as yields have fallen steadily in the past four years and no longer offer attractive potential returns for the risk involved.
- We believe that this timeframe doesn't reflect an accurate picture, since four years ago yields were exceptionally high. Currently 10-year bank FRN spreads are actually trading around their 10-year average.
- There are differences in the market among various issuers – highly rated companies have become even more expensive than their lower-rated counterparts. The narrowing of credit spreads can be attributed to new regulations requiring banks to hold more highly rated debt, as well as to improved liquidity
- We see an opportunity in one-year bank FRNs that are offering attractive yields vs the risk involved.

Prudential has always seen corporate credit as a core asset class within the fixed income investment universe, since it can add value to our clients' portfolios through the extra yield (or spread) it offers – but only where appropriate for the risk involved. We take pride in our robust credit research process, which we have followed for nearly 20 years. This reflects a similar investment focus on credit as that of our largest shareholder, M&G Investments, which runs one of the larger European credit investment teams. We have been active in the local credit market from its inception in the early 2000s, successfully navigating the Global Financial Crisis (GFC) in 2008 and other difficult periods, to today.

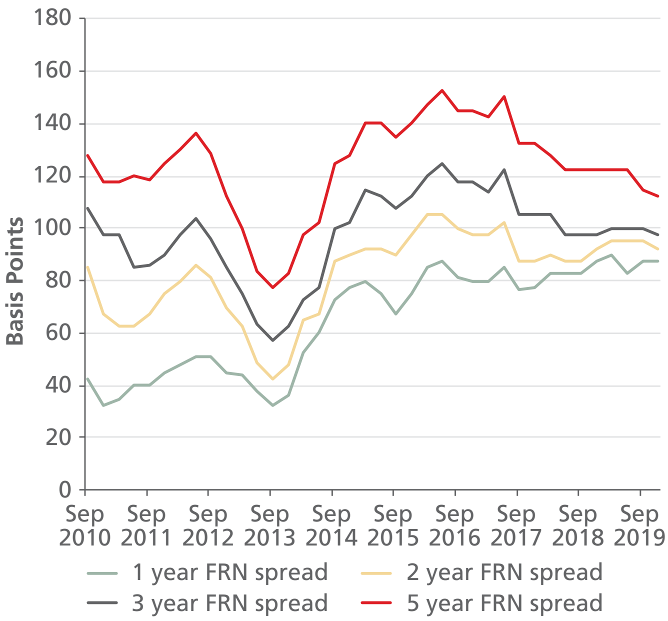
There is currently a debate in the local investment industry over floating-rate corporate credit (in the form of floating-rate notes or FRNs), and whether this debt has become too expensive, particularly for higher-quality issuers. This would mean that the yield these assets now offer is insufficient for the risk involved. Low- to medium-risk unit trust funds, which have benefitted from strong investment inflows over the last few years, have been particularly active in deploying these new investment inflows into this part of the fixed income market.

Prudential's view

At Prudential, we do not believe local floating rate credit is currently expensive. This is despite the fact that, in the past four years, the extra yield offered by FRNs has fallen (as shown by the spreads in Graph 1), no longer providing as much additional compensation as it did previously. In analysing this move it is important to provide some historic context, and in particular to consider the starting point of the analysis. We think this historic context is important, as most discussions around "how expensive credit is" appear to be anchored to the market's experience over the last four years.

Six years ago, in 2014, South Africa's fixed income market had suffered a significant repricing in interest rates and spreads from the lows experienced in 2013. First had come a sharp sell-off in April 2013 across most global markets of bonds and other shorter-dated notes and loans, in what has been termed the global "taper tantrum" (sparked by US Federal Reserve Chairman Ben

Graph 1: SA Bank floating rate credit spreads narrow



SOURCE: Bloomberg; Uses floating-rate bank certificates of deposit spreads as a proxy for credit market pricing trends

Bernanke saying the US planned to start removing monetary support for the economy). Then in September 2014, the local market experienced the largest South African capital market default ever – African Bank. This further exacerbated the sell-off and pushed spreads even higher in the 18 months thereafter as clearly shown in the graph. We would argue that the debate around the level of credit spreads within the context of the last four years fails to take into account the particularly elevated starting level of spreads given the market context.

"Six years ago, in 2014, South Africa's fixed income market had suffered a significant repricing in interest rates and spreads from the lows experienced in 2013."

In fact, the longer 10-year period depicted by Graph 1 highlights that currently bank credit spreads look to be trading around their 10-year average levels. It's also worth noting that they are significantly above their pre-GFC levels. So while it is true that spreads have tightened and yields have compressed, particularly over the last three years, in a longer-term context they do not look expensive.

Extra yield vs extra default risk

It is important to consider what spread investors should earn to compensate for the risk of default. As most will know, South Africa has suffered a series of sovereign credit rating downgrades in the past two years, and some South African corporate ratings have also been lowered, due largely to the weak economic environment. Investors should consider how much more yield they require as compensation for the increased risk of default by companies. The table overleaf shows

Credit Rating	Probability of Default (10 yr)*	Extra yield for Default risk**
AAA	0.13%	0.02%
AA	0.74%	0.03%
A	2.14%	0.09%
BBB	3.42%	0.29%
BB	15.26%	1.21%

*Moody's - Average Cumulative Issuer-Weighted Global Default Rates By Letter Rating, 1983-2018
**Assumes a 20% recovery (1980-2018)

SOURCE: Deutsche Bank, Moody's Investor Services, S&P Global

what spread (extra yield) investors should require to compensate for the risk of default, based on the historical default experience in the US market at the 10-year tenor point.

With South African bank debt rated BBB by Moody's, this 0.29% additional yield should be reflected in our bank FRN spreads. Currently, these spreads are around 1.50%-1.60%, significantly higher than the table would suggest investors should require. Clearly, investors also need to be compensated for additional risks such as volatility and the lower liquidity or tradability of corporate credit, but these figures do put the spreads available to investors into context.

It is also worth highlighting that at an individual issuer level there can be borrowers whose credit is expensive and those whose credit is cheap. At Prudential we are very selective – we can point to a number of examples where we have not bid on individual corporate issues because we felt the spread on offer was not compelling enough. There are also occasions where we have bid at a higher spread than the market clearing price because our analysis indicated that a higher level was appropriate for the risk.

Examples of corporate credit that has become expensive and where spreads have fallen in the past five years include highly rated borrowers like Toyota and Mercedes Benz. Because their credit ratings are above that of South Africa's own sovereign rating, reflecting their foreign owners' creditworthiness, they have always been highly sought-after. But in the past five years their spreads have narrowed even further – partly because regulations have encouraged banks to hold these instruments and have led banks to become more active in the credit market. The latter has made this market somewhat more liquid than in the past, helping reduce the extra yield investors require for a lack of liquidity. Arguably, the lower spreads that have been observed are as much a function of improved liquidity as anything else.

The FRN market in South Africa

In South Africa, FRNs make up about 16% of the total primary debt listings on the JSE. FRN issuance is mostly dominated by the "big four" banks, while also including companies as diverse as Netcare, Mercedes Benz South Africa and property companies. The South African government, unlike many other emerging market governments, does not issue FRNs, although some state-owned enterprises (SOEs) and municipalities do.

In the local market, FRN coupons are set based on the three-month Johannesburg Interbank Agreed Rate (JIBAR), which, simplistically, is the average of South African banks' three-month interest rates. The FRN issuer pays a margin above JIBAR that reflects the risk lenders believe is inherent in the note, with the margin determined by factors including the issuer's credit risk (based on its credit rating), the length of the loan (also called the 'term') and the liquidity of the instrument (how easily it is traded). The poorer the credit rating, longer the loan, and lower the liquidity, the higher the margin (or spread) above JIBAR.

So how does it work? Suppose that a company wants to borrow R150 million over three years. It issues a R150 million three-year FRN with a coupon of three-month JIBAR plus 200 basis points (bps), or 2.00%. Initially three-month JIBAR is 6.6%, so the coupon paid by the company is 8.6%. Every quarter thereafter the coupon adjusts to reflect the prevailing JIBAR at that time. For instance, if after 3 months three-month JIBAR rises to 7.1%, the coupon will be re-set, increasing to 9.1% for the next three-month period.

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"Examples of corporate credit that has become expensive and where spreads have fallen in the past five years include highly rated borrowers like Toyota and Mercedes Benz."

Opportunity in one-year bank FRNs

One area of the market which does appear to offer a buying opportunity based on their relative value is one-year bank FRNs, where yields still remain elevated compared to their history. We ascribe this to the regulatory changes introduced within the banking sector following the GFC. These changes, amongst others, have encouraged banks to lengthen the term of their wholesale funding, which has served to keep the one-year tenor elevated versus history. We expect this effect to be an enduring feature of the local market. As such, within our various funds like the **Prudential Income and Enhanced Income Funds** we have sought to take advantage of this phenomenon and continued to add exposure to this area of the curve.

The Prudential Income Fund, now with its three-year performance track record, has certainly benefited from this FRN exposure, having outperformed its benchmark (the STeFI Composite Index) with a return of 8.6% p.a. vs 7.4% p.a. since its inception in December 2016.

In conclusion, it takes the careful, consistent application of a robust credit investment process to uncover the opportunities in the corporate credit market that can help to add value to our clients' portfolios. For us, the focus is on whether the value justifies the risk involved. Over the past two decades this valuation-based process has proved its worth, through all market cycles. ■

Gareth joined Prudential in 2004 as a Credit Analyst and was appointed as Head of Fixed Interest in April 2018. Prior to joining Prudential, he completed his articles at Ernst & Young and qualified as a CA (SA) in 2003. With 15 years' industry experience, Gareth holds a Bachelor of Business Science degree in Finance and a Bachelor of Commerce (Hons) degree in Accounting, both from UCT. He is a qualified CA (SA) as well as a CFA charterholder.

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SA equity returns in 2019: Decent or a disappointment?

Clare Lindeque
HEAD OF QUANTITATIVE ANALYSIS

KEY TAKE-AWAYS

- It's very important that investors understand which equity index is used in managing their portfolios, to avoid confusion over returns and to ensure they have the most appropriate measure to meet their own investment goals.
- There are four broad SA equity indices commonly used, and each has their own merits. Each also outperforms depending on market conditions, none regularly outperforming another.
- Prudential, along with many other investment managers, uses the Capped SWIX Index in managing most of our unit trusts due to it being the most accurate representation of the SA equity universe available to investors, its lower risk characteristics, and its ability to deliver returns comparable to the other broad SA market indices.

Table 1: Different SA equity indices outperform in different years (Total annual returns, %)

Index	2019	2018	2017	2016	2015	2014
SWIX	9.3	-11.6	21.2	4.2	3.7	15.5
Capped SWIX*	6.8	-10.9	16.5	5.1	2.8	15.4
ALSI	12.1	-8.4	21.0	2.8	5.3	10.9
Capped ALSI (CAPI)	10.6	-7.6	18.2	4.1	5.3	11.1

*Capped Swix returns prior to 2017 based on JSE's calculated history

SOURCE: Bloomberg

Either South African equities returned 12.1% in 2019, a decent result in line with the long-term average, or they delivered 6.8%, certainly disappointing when compared with their history. Which is correct? As an investor, it can be perplexing when the numbers differ so much. Anyone hearing that the FTSE/JSE All Share Index (ALSI) returned 12.1% – the most widely used measure in news reports – would be disappointed to learn that it was actually the 6.8% from the FTSE/JSE Capped SWIX Index (a very common index used by investment managers) that was most applicable for their portfolio's equity performance.

In truth, as Table 1 shows, both results are valid, and in fact there are several correct return measures for our equity market for 2019. South Africa has four different broad indices that measure equity performance, and it's important to know which of the four is most relevant to your portfolio. All four have outperformed in recent years, depending on market conditions. Here we take a closer look at the South African equity market indices, and why their performance diverged so much in 2019.

Which SA market indices are available?

In the FTSE/JSE suite of broad market South African equity indices, the headline index is the All Share Index (ALSI), which has been in existence – in one form or another – for decades. The Shareholder Weighted All Share Index (SWIX) was introduced in 2002. The share universe for these two indices is identical, comprising 99% of the full market capitalisation of equities listed on the JSE's main board. Market capitalisation (or market cap) is the value of a company, determined by the number of its shares in issue multiplied by its share price. An index's

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value or market cap is therefore the sum of all the individual companies included in the index. Currently this universe comprises 158 companies.

The ALSI and SWIX differ in how their constituents are weighted. Both are weighted by their market cap and their free float; the larger a company's market cap, the larger its index weight, before any other adjustments are applied.

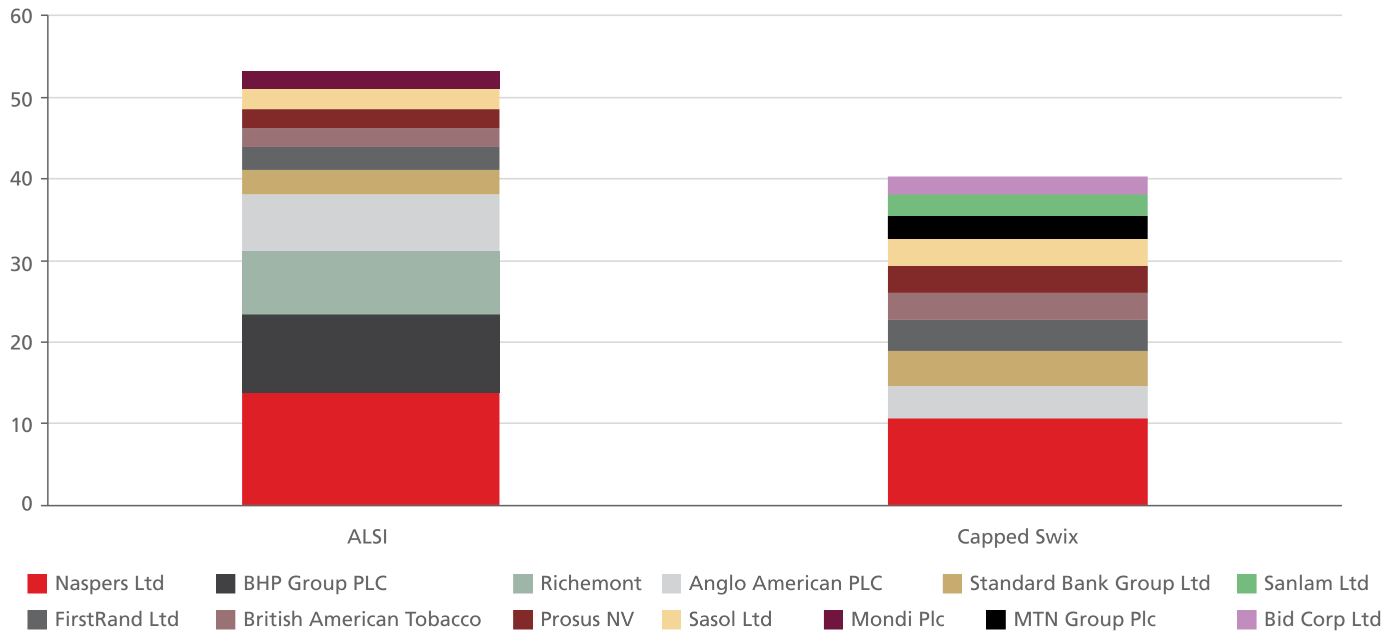
There are also liquidity and free float requirements for index inclusion. Liquidity refers to the ease of trading of a share, which can be impacted by its scarcity and how often it trades.

Meanwhile, free float is the portion of a company's common stock that is freely tradeable. Any equity tied up in strategic ownership by other companies, owned by employees, or whose sale is subject to lock-in clauses, for example, is excluded from a company's free float. Both the ALSI and the SWIX index weights are adjusted for free float, but some of the ALSI weights have a quirk related to this.

Here's the quirk. Since 2013, all foreign stocks that have sought an additional listing on the JSE have had their ALSI and SWIX weights calculated based

Graph 2: Top 10 company weights in ALSI vs Capped SWIX

As of 31 December 2019



SOURCE: Bloomberg

"Notably, South Africa's equity market is among the most concentrated in the world"

on a SWIX free float factor. This is a weighting scheme where only the portion of each company's freely traded share capital that is held on the South African shareholders' register is counted towards the share weight – hence the origin of "shareholder weighted" index. However, those stocks with foreign listings on the JSE prior to 2013 were able to retain their previous ALSI weights based on their full market cap, and are not subject to SWIX free float.

Consequently, these "grandfathered" companies, for whom the shares held by South African investors may represent only a small portion of their total shares outstanding, have higher weights in the ALSI than in the SWIX. Examples include BHP Group, Richemont, Investec plc and Anglo American. This has also contributed to the higher weighting of the Basic Materials sector in the ALSI (30.8%) than the SWIX (20.2%). In 2019, this was one of the drivers of the outperformance of the ALSI over the SWIX, as we explain later.

Index concentration and capped indices

A significant shortcoming of market cap indices, but one that reveals itself only a few times in a generation, is the fact that this weighting scheme can lead to a massive concentration of index weight – and single stock risk – in companies or sectors that grow at an outsize rate in comparison to their peers. When an index has a large portion of its weight in a small number of stocks or certain sectors, it is referred to as a concentrated index.

Notably, South Africa's equity market is among the most concentrated in the world. It's well known that in the past the dominance of the resources sector (and Anglo American and BHP in particular) during peak commodity cycles presented undue risk to local investors. This particular over-representation has now waned in line with global commodity prices. More recently, Naspers has been the heavyweight stock of most concern to investment managers, having peaked at 26.9% in the SWIX in early April 2019. This was before its separate listing of Prosus in Amsterdam, which has brought its weight down to 17.7% in the SWIX as of the end of 2019.

The implications of index concentration are potentially serious; companies that grow at a wildly disproportionate rate in comparison to their peers rarely maintain this colossal size. Furthermore, investors in market indices – or in tracker or passive funds benchmarked to market indices – dominated by few stocks are exposed to a large amount of specific risk. This is risk that is particular to each company, or to a sector; it is also the kind of risk that you can diversify away by holding a well-balanced portfolio. You'd advise your grandma against investing all her savings in one stock; the case of investing in a highly concentrated index is analogous.

To mitigate against single-stock risk, the JSE introduced two capped indices: the Capped All Share (CAPI) in 2003 and the Capped Shareholder Weighted Index (Capped SWIX) in 2016. These indices comprise the same universe of companies as the ALSI and SWIX, but the maximum individual stock weight is capped at 10%. The weights of other stocks in the index are slightly increased as a result. The CAPI follows the ALSI weighting scheme, and the Capped SWIX follows the SWIX.

Because the SWIX and capping methodologies limit the weighting of offshore and larger companies in their indices, there ends up being some significant differences in composition between the headline ALSI, which most people commonly refer to when following the market, and the Capped SWIX. Graph 2 compares the top 10 shares by weight in each index. It highlights two of the most notable differences, which are the underweighting of large global companies in the Capped SWIX, and the higher concentration risk in the ALSI.

Index performance in 2019

It is impossible to predict whether one benchmark index will outperform another in a given year. In fact, if we had that kind of foresight, we'd be using it in other ways! As you can see from Table 1, there isn't any one particular index that systematically outperforms the others; capped SWIX was the top performing of the four FTSE/JSE indices in 2016. Depending on how market prices move, the characteristics of different index construction methods manifest themselves.

It is, however, possible to explain relative index performance after the fact. Taking a broad view of 2019's return differential between the ALSI and the Capped SWIX , the underperformance of the Capped SWIX was attributable to its smaller exposure to the large global stocks, many of which performed strongly in 2019. More specifically, the three primary reasons were due to differences in index weighting in 1) the Basic Materials sector, 2) Naspers and 3) Richemont.

First, the best-performing sector in the SA market for 2019 was Basic Materials, which includes gold, platinum, and diversified mining companies. Some of these stocks – particularly the gold and precious metal (platinum, rhodium, palladium) miners – generated returns in excess of 100% for the year. These returns were driven by surging palladium and rhodium prices, underpinned by increased demand, and a rallying gold price thanks to its safe-haven status on the back of elevated geopolitical risk.

The ALSI has a higher weight in dual-listed resource counters than the SWIX (and thus than the Capped SWIX, too). For example, the ALSI's weight in BHP was 9.6% at the end of December 2019, whereas its Capped SWIX weight was only 2.1%. Overall, Basic Materials contributed 7.3% of the ALSI's 12.1% total return for the year, and 5.3% of the Capped SWIX's 6.8% annual total return.

The second most significant contributor was their weights in Naspers, which represented 13.8% of the ALSI and was constrained to only around 10% of the Capped SWIX. Naspers delivered a 19.9% total return for 2019, thus contributing 3.8% to the ALSI total return, and only 1.9% to the Capped SWIX total return.

The final major difference was their respective weights in Richemont, one of the grandfathered companies, that had a weight of 7.8% in the ALSI and 1.8% in Capped SWIX at the end of 2019. Richemont returned 20.1% for the year; as a result it contributed 1.4% of the ALSI's 12.1% total return, and only 0.3% to Capped Swix.

Interestingly, for both indices, the remainder of the shares in the market (excluding Basic Materials, Naspers and Richemont) produced a negative total return in aggregate.

Choosing our equity index

At Prudential, for our institutional or segregated clients, we manage their portfolios using the indices that they request - those that are best aligned to their unique requirements.

Where we have full discretion as to which index to choose for our clients, such as in our retail unit trusts, we use the Capped SWIX Index. This holds true across all of our equity and multi-asset portfolios where our aim is both to protect and grow our clients' longer-term retirement savings. That protection involves limiting potential negative returns from event-specific risks, like a market crash, as well as SA-specific risks, such as those related to certain companies, sectors or unique market conditions.

In analysing our market indices, we know that the SWIX best represents the share universe available to a South African investor. For example, all South African managers could not hold a 7.8% position in a dual-listed company like Richemont (its ALSI weight), as this weight includes shares listed in Switzerland, which a 100% locally restricted fund could not access.

Equally, we prefer Capped SWIX to SWIX because it somewhat reduces the very high concentration risk in our market by setting the maximum index weight to 10%. By incorporating the Capped SWIX into our investment process, we are implicitly limiting portfolio downside. Additionally, our investment process features explicit maximum limits for portfolio weightings of 5% for each sector, and 4% for an individual stock, as further layers of protection.

Know your index

In conclusion, we believe it's very important for investors to understand which SA equity index is most suited to their own investment goals and risk appetite. Be aware of the risks involved, like market concentration risk. For those preferring to have their investment manager choose for them, then they should know which index they use and why. This is especially true in passive investing, where the fund tries to replicate the index exactly.

For Prudential's South African equity portfolios, our preference for Capped SWIX is based on its appealing combination of improved risk characteristics over the more concentrated indices, and its ability to deliver returns comparable to the other broad SA market indices. It's a choice we are confident will keep delivering strong returns for our clients over the years. ■

Clare joined Prudential in 2007 and is the Head of Quantitative Analysis. With 17 years of industry experience, she has worked in a range of roles spanning quantitative analysis, marketing and web development. Claire holds a Master of Science degree in Financial Mathematics from the University of Cape Town, a Financial Risk Manager certification from the Global Association of Risk Professionals and is also a CFA charterholder.

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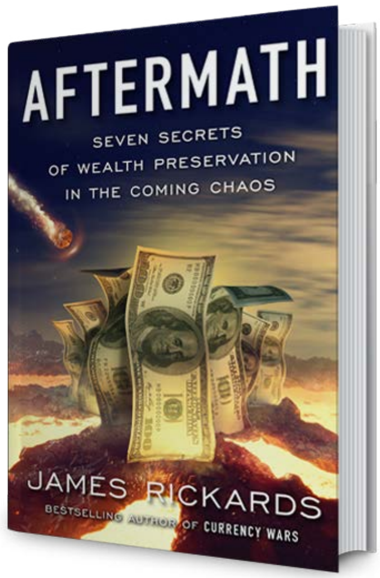
Is the future all about wealth preservation amid chaos?

Roshen Harry
PORTFOLIO MANAGER



"Aftermath: Seven secrets of wealth preservation in the coming chaos" touches on many economic and geopolitical scenarios and themes, some undoubtedly unpleasant, but nevertheless makes for a fascinating read. The author, James Rickards, is an American lawyer, speaker, gold speculator, media commentator, author on financial topics, and precious metals expert. He is the author of Currency Wars: The Making of the Next Global Crisis (2011) and five other books.

In this, his latest forward-looking tome, Rickards holds quite a pessimistic view of what is likely to unfold from the current global economic conditions. He believes that a US recession – even a global economic crisis – is coming and that the US Federal Reserve (Fed) will be powerless to fight it. Investors, therefore, should be primarily concerned with preserving their wealth in the years ahead.

There is a large focus on the "aftermath" of the 2008 Global Financial Crisis (GFC) and policy actions taken by central bankers to revive growth. Rickards contends that this crisis never really ended and that more is to come. I will touch on the themes I consider to be most relevant today: the Fed, public debt and income inequality.

The Fed

Rickards contends that the Fed is not ready for the next recession, since, according to historic research it takes 300 to 500 basis points (3-5%) of interest rate cuts to pull the US economy out of recession. Meanwhile, at the beginning of 2019 the Fed Funds rate was 2.5%, so it is impossible to cut it by 3% to 5% to fend off another recession. A fourth round of quantitative easing (bond purchases, or QE4) would be another alternative tool to soften the blow of a recession; however the Fed has not normalised its balance sheet, which has expanded from US$800bn to US$4.4trn by printing new money in previous rounds of QE. In addition, he argues, the beneficial wealth effects of previous QE programmes never transpired into additional borrowing and consumption by consumers, only into higher asset values which have, in turn, translated into bond and equity market bubbles. And these, are now **bubbles waiting to burst.**

So any QE4 plan would start from a higher base (almost R4trn) compared to R800 billion when QE1 was first initiated. There are some academics who see no problem with the Fed printing an unlimited amount of money, but Rickards believes this is flawed as there is an **invisible confidence boundary** beyond which everyday citizens will lose confidence in the Fed and the US dollar. Where this boundary is no one knows, but as he says, it's best no one finds out the hard way!

Addressing the idea of using fiscal policy to spend the US and other countries out of a recession by going further into debt, he cites research by professors Carmen Reinhart and Kenneth Rogoff, which shows that once a nation's debt/GDP ratio passes the 90% level, the stimulative impact from additional debt is negative, with median growth rates falling by about 1%. "The law of diminishing marginal returns start to bind."

"Since the 2008 GFC, the US national debt has roughly doubled from $10trn to $20trn - debt which is unsustainable given the low growth over the past 10 years"

At lower debt/GDP ratios, the research suggests, the relationship between debt and GDP is not strong and other factors guide growth, including tax, monetary policy, and trade policy, etc. Once the 90% debt/GDP level is breached, debt becomes a dominant factor. This is corroborated by research performed by the European Central Bank (ECB) and the Bank for International Settlements (BIS) on the impact of government debt on growth. The ECB report concludes that "a higher public debt/GDP ratio of 90% to 100% is associated on average with lower long-term growth rates". As expected, there are other economists who are scathing of the above and advocate fiscal stimulus to prevent structural unemployment in an economy due to lost skills.

Since the 2008 GFC, the US national debt has roughly doubled from $10trn to $20trn - debt which is unsustainable given the low growth over the past 10 years compared to previous post-recession growth rates, Rickards says. This environment of slow growth, high debt and income inequality is a global phenomenon and not confined to the US only.

So what should the Fed do?

According to Rickards, the central bank needs to raise rates slowly, reduce its balance sheet (by selling bonds) and hope that the recession does not occur before it gets policy rates and leverage back to normal levels, which he thinks could happen by 2021. Unfortunately, he also believes that the odds of a recession occurring before 2021 are high, and that when a recession hits the US it may last for decades -- much like Japan, which has now lost three decades of growth.

For him the Fed is in a difficult position: it may cause the very recession it is trying to avoid if it acts too quickly. Alternatively, move too slowly and it may run out of time. Any resulting recession and deflationary period are a central banker's worst nightmare, as it increases the real value of debt, leading to defaults. It discourages consumption and increases the real standard of living of consumers, which cannot be taxed.

What about emerging markets?

In Rickards' scenario, emerging markets will not be left unscathed. Emerging market debt has been growing at a record pace fuelled by investors chasing higher yields. He thinks we are in the midst of another emerging markets debt crisis, based on the current examples of Turkey, Argentina and Venezuela, while South Africa, Ukraine and Chile are "highly vulnerable" to a run on their reserves and a default on their foreign currency-denominated debt.

Prudential differs with Rickards' view that South Africa is highly vulnerable to a run on reserves or default on its foreign currency debt, primarily because its foreign currency-denominated debt is a small proportion of its overall debt stock (only around 10%). This could be financed in the local market if necessary. Also, South Africa has one of the world's longest government debt maturity profiles (second only to the UK), so that its debt (both foreign and rand-denominated) is largely repaid over long periods of time. And although almost 37% of South Africa's overall debt stock is held by foreign investors, we would argue that South Africa is in a relatively strong position as far as exposure to external debt is concerned.

Interestingly, he notes that the problem is not generally with individual sovereign defaults, but one of **contagion**. When one emerging market defaults, funders lose confidence and panic sets in; emerging market assets are simply sold off with no buyers in sight, resulting in a sudden fall in asset prices.

Rickards contends that the debt crisis has already begun, and a full-blown emerging market debt crisis is likely to occur soon. He predicts that the IMF will run short of resources, European countries will focus on their own problems and the US with Trump's "America First" rhetoric will decline to assist.

Income, Inequality and Levelling

The author paints quite a grim series of future scenarios which seem rather unlikely, for example financial disruptions that go beyond capital market dislocation impacting critical infrastructure and then a breakdown of social order. He contends that research performed by sociologists and historians suggests that once critical systems break down, it takes three days before the "law of the jungle" prevails and civilisation as we know it breaks down. Violence, looting and the formation of vigilante groups emerge, amongst others.

One may think that surviving a societal collapse requires one to have access to bunkers, private jets and fire arms. Not so, he says, community will serve you better, a community that is willing to share food, water and labour. Cities will fare worse than the countryside because cities rely on electricity and complex networks that are vulnerable to sabotage.

In South Africa and generally abroad there is growing income inequality. Rickards refers to Walter Scheidel's book, "The Great Leveler", which examines income inequality and its remedies. Remedies most people are familiar with include land redistribution, progressive income tax and higher estate taxation, free education, access to good schools and pre-school programs, and universal health care, amongst others.

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The author concludes that none of these solutions has any chance of becoming law on a meaningful scale to materially impact on income inequality in the US. Key to note, though, is that this does not mean income inequality is never levelled. Societies periodically experience what Scheidel calls **levelling** - the gap between rich and poor is narrowed. However, as he highlights, this happens under the most of unfortunate circumstances: death and violence in the form of war, revolution, plague or systemic collapse.

"...a robust contrary view such as that proposed by Rickards provides a useful sounding board to conventional thinking"

So, if Rickards' predictions (however unlikely) hold true, all will not be well with the wealthy in the future. He offers some investment ideas that could prove helpful, which are listed alongside.

Seven secrets of wealth preservation in the coming chaos

1. Tariffs and trade surpluses are back. Prepare for a more mercantilist world as Trump refuses to play the free trade game. He suggests America will find new domestic champions in areas of steel, renewables, autos and transportation. The hallmarks of mercantilism are the accumulation of gold and silver.
2. Prepare for slow growth and periodic recessions for decades to come.
3. Beware of behavioural manipulation nudging you in a certain direction.
4. Diversify away from exchange-traded markets. Allocate to cash, gold (preferably held in a safe, non-bank place) and alternative assets.
5. Low productivity may mean inflation or deflation.
6. Prepare for new currencies backed by physical gold.
7. Allocate to alternative assets.

Of course Prudential does not suggest that investors follow this advice (apart from #3 which is a well-accepted investment guideline). Our own analysis is rather less apocalyptic; local and global equities both appear priced to deliver decent real returns over the next five years as long as the world economy avoids a recession. Local bonds are also pricing a good dose of negative news, with real yields approaching mid-single digits, a substantial risk premium. Prudential multi-asset portfolios are overweight both. Nevertheless, a robust contrary view such as that proposed by Rickards provides a useful sounding board to conventional thinking and to that extent, we recommend it to our clients. ■

Roshen joined Prudential in 2006 and is the joint-Portfolio Manager of several Prudential funds. With 19 years' industry experience, Roshen completed his articles at Deloitte & Touche before joining Rand Merchant Bank in their Risk and Compliance division. He holds a Bachelor of Commerce degree and a Post Graduate Diploma in Accounting, both from Rhodes University. He is a qualified CA (SA) as well as a CFA charterholder.

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