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Prudential: Exploiting opportunities and avoiding risks

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KEY TAKE-AWAYS

- SA equities and nominal bonds are priced to deliver very attractive real returns over the next three to five years, and we have been adding these assets to client portfolios where appropriate.
- SA cash and offshore assets have become less appealing, as prospective returns have declined in recent weeks, mainly due to interest rate cuts and rand depreciation.

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At Prudential we are cautiously optimistic that with patience, time and astute active portfolio management, investor portfolios can recover their values, enabling clients to meet their investment goals over time. We have been positioning our client portfolios both to benefit from the exceptionally low valuations now available, and to avoid the assets that have become more risky. Active portfolio management has been key, as the large and rapid market moves during the global sell-off have changed prospective investment returns significantly. Following is an overview of some of the noteworthy adjustments we have made in recent weeks.

SA equities and bonds offering exceptional prospective returns

Regarding SA equities, our analysis shows that, as of 15 April, the FTSE/JSE Capped SWIX Index) was priced to deliver a prospective real return of around 10.6% p.a. over the next three to five years, far higher than the 6.5% p.a. historic average. We have been adding exposure to companies with strong balance sheets, steady cash flows and defensive-quality earnings that we believe can successfully weather the economic downturn. In the sell-off we saw opportunities to buy some of South Africa's top blue-chip companies at excellent valuations. On the other hand, there are also companies that are trading very cheaply for a reason – because their risk has increased sharply.

"...10-year nominal bonds should deliver a real return of approximately 5.4% p.a. over the next three to five years, more than double the 2.5% p.a. historic average"

SA government bonds are also offering an excellent opportunity to capture exceptional returns following their sell-off. Based on our analysis as of 15 April, 10-year nominal bonds should deliver a real return of approximately 5.4% p.a. over the next three to five years, more than double the 2.5% p.a. historic average. We have been taking advantage of this by adding SA bonds to our portfolios wherever possible. Although more volatility is likely, we would not expect to see significant further weakness from these valuation levels, and we believe

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current bond yields largely reflect the risks involved.

SA cash and offshore investments less attractive

In contrast to SA equities and bonds, however, SA cash investments have become much less attractive following the South African Reserve Bank's 2.00% reduction in interest rates: SA cash is now offering an estimated real return of only 0.2% p.a. going forward, barely above inflation. For investors who have been holding high levels of cash because of its outperformance of SA equities in the last three years, this positioning is now much riskier. Not only will its future returns be lower in absolute terms, but it is also much less likely to beat returns from SA equities. Holding more cash than absolutely necessary will considerably reduce the chances of a full portfolio recovery the longer it is held.

Investors should also be cautious about increasing their offshore exposure going forward. The potential future returns from global assets have become less attractive relative to local assets due to both the depreciation of the rand, and because developed market asset valuations are more expensive than those in South Africa. The rand has lost about 25% of its value and is currently undervalued, making it likely more to appreciate over time. This would detract from future offshore returns.

Additionally, our analysis shows that global equities, as measured by the MSCI All Country World Index, are priced to deliver a real return of around 6.0% p.a. over the next three to five years, very close to their 5.9% p.a. historic average. So they are not cheap on an absolute basis (having been valued somewhat expensively before the Coronavirus downturn), nor are they cheap relative to SA equities, which potentially offer a substantial 4.6% p.a. more going forward. At Prudential we have been taking advantage of this by selling some of our offshore equity holdings to buy up better-valued SA equities and SA nominal bonds, at the same time buying cheap rands with expensive US dollars.

Finally, due to the sharp cuts in interest rates around the world to help stimulate economic growth,

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global bonds and cash have become even more unattractive. Real yields have moved even deeper into negative territory in the major markets like Europe, Japan and the UK, and now even US real yields are hovering near 0%.

In conclusion, with such a wide variety of assets offering excellent prospective real returns from their current levels, the chances are very good that investor portfolios will be able to deliver above-average performances compared to their history. SA equities are priced to deliver real returns of over 10%, and nominal bonds and ILBs more than double their long-term average real returns. SA cash, meanwhile, is no longer able to deliver meaningful inflation-beating returns like it has during the past three years. Astute active management with careful diversification should go a long way to helping our clients meet and beat their investment goals over time. ■

With 12 years' experience, Sandile joined our fixed interest team in November 2013 and later joined the multi-asset team in 2018. He is a joint-Portfolio Manager of several Prudential unit trusts, including the Balanced and Inflation Plus funds, as well as the Money Market, Income and High Interest funds. He holds a BSc in Mathematical Statistics and Actuarial Science and is a Student member of the Faculty of Actuaries.

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