PRUDENTIAL
INVESTMENT MANAGERS

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Prudential Balanced Fund: Set to deliver excellent risk-adjusted returns

Following the sharp sell-off across global financial markets induced by the Coronavirus crisis, South African investors are understandably worried about the values of their portfolios. Yet despite the ongoing market volatility and uncertainty about future economic growth, at Prudential we believe now is a very good time to invest in well-diversified balanced funds, especially for longer-term investors looking for solid inflation-beating returns over time. Even though investors may be reluctant to invest in these funds due to their recent historical underperformance, they should actually consider embracing them even more.

Our analysis shows that a great deal of bad news has already been priced into our markets, presenting a rare opportunity to invest across different asset classes at very attractive levels simultaneously. SA equities, bonds and inflation-linked bonds have been trading very cheaply – as has SA listed property (although with much more associated risk). This means that balanced funds have a very good chance of delivering much higher returns than their historic averages, and investors are likely to get the strong returns they need from several different asset classes, lowering total portfolio risk.

First, SA equities have given investors some excellent buying opportunities: the FTSE/JSE ALSI ended March at a price/book value ratio of around 1.1X, a 40-year low and below the levels reached during the Global Financial Crisis (GFC). And by the end of April it was trading at only around 1.3X, in line with the GFC. Prudential has taken advantage of the very low valuations on offer, while being mindful of the higher risk that has emerged for many companies. We have been careful to select high-quality companies that should help our client portfolios weather the difficult conditions ahead.

For example, we have added Bidcorp exposure in the Prudential Balanced Fund. Bidcorp is a high-quality business, as demonstrated by its history of delivering steady compound growth in profits over time, as well as having a strong balance sheet. We have also increased our holdings in Remgro and MTN after their shares reached substantial discounts. Remgro had the additional attraction of the unbundling of its stake in RMH, while for MTN we saw nearly 40% upside potential in its share price, even after incorporating further discounts for future currency depreciation and other potential negative developments.

Meanwhile, the fund's top holdings include global giants like Naspers, British American Tobacco (BAT) and Anglo American, all of whose share prices held up relatively well in the past few months - and should continue to do so. Naspers' online gaming and other services benefited from the global lockdowns, especially in China, while BAT has solid, defensive-quality earnings and Anglo American's operations are highly diversified across commodities and geographies. These equity holdings, among others, give the Prudential Balanced Fund potential to deliver above-market returns going forward.

Turning to the fund's bond exposure, it has been overweight SA government bonds for some time now, and within this has been holding mostly long-dated bonds with maturities of 20+ years. We added to this long-dated positioning as yields rose to exceptionally attractive levels of over 13% in March and were still trading over 11% in April, which we believe will more than compensate investors for the risk involved. Assuming inflation averages 4.5% (the mid-point of the SARB's targeted inflation range), they offer investors a prospective real return of around

6.5% p.a. over time - a level equivalent to that of equities, and with less risk.

Looking at offshore assets, we do believe it's important to continue to hold foreign equities for their exposure to faster-growing economies and as an excellent diversifier. However, the valuation of the MSCI All Country World Index fell to a price/book value ratio of only around 2.0X at its March low, near its longer-term average and not offering a discount compared to SA equities. With the rand's sharp depreciation in the past weeks, we opted to trim our overweight position in foreign equities and add to SA equity and SA bond exposure. Still, foreign equities are priced to deliver around 5.5% p.a. over the next five years, we believe, a very solid real return.

Lastly, cash is the one SA asset class where prospective returns are now much lower, due to the large interest rate cuts from the SARB. Long-term investors should consider reducing their exposure where appropriate, given that cash is no longer even beating inflation – the Prudential Balanced Fund has very little cash exposure.

Given this positioning and asset valuations, we are confident investors in the Prudential Balanced Fund will benefit from equity-like returns, but with much lower risk, over the next five years or so. Patient investors should be rewarded. Now more than ever, balanced funds should be the core of a long-term investment portfolio.

For more information on our funds and how to invest, speak to your financial adviser or call our Client Services Team on 0860 105 77, or email us at **query@prudential.co.za**.