TABLE TALK

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KEY TAKE-AWAYS

- Most local asset classes have been trading well below their long-term value in recent months. Our analysis shows that a great deal of bad news has been priced into our markets, which has presented a rare opportunity to invest across different asset classes at very attractive valuations simultaneously.
- Balanced funds with well-diversified exposure are therefore a sound solution for long-term investors looking to beat inflation over time.
- We believe the Prudential Balanced Fund has a very good chance of delivering much higher returns over the next three to five years than its historic averages, and investors are likely to get the strong returns they need from several different asset classes, lowering total portfolio risk.

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Q I'm a long-term investor and worried about the outlook for investment returns since South Africa seems to be facing an extended period of low growth. Even offshore, growth prospects are much weaker due to the impact of the Covid-19 pandemic. Where does Prudential think I can get the best risk-adjusted returns over the next five to 10 years? For me it's not just about getting the highest returns, but also about managing the downside risk after such a big downturn in March.

A Despite the market volatility and uncertainty around the outlook for South Africa's economic growth, you should be encouraged to know that at Prudential we are cautiously optimistic about investment returns over the next five years or so. This is particularly true for investors (like us and our clients) who have been able to take advantage of the excellent valuations we've seen across most local asset classes in the past three months.We believe it has been a very good time to invest in well-diversified balanced funds, and continues to be so, especially for investors looking for solid inflation-beating returns over the longer-term. While we fully understand that investors may be reluctant to consider these funds given their recent below-average performance, this is exactly why they should be considering embracing them even more at this point in time.

Our analysis shows that a great deal of bad news has already been priced into our markets, which has presented a rare opportunity to invest across different asset classes at very attractive valuations 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

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higher returns over the next three to five years 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 due to the indiscriminate selling of all stocks during the March downturn, leading to very attractive valuations on offer: the FTSE/JSE ALSI ended March at a price/book value ratio of around 1.1X, a 40-year low, and by the end of April it was trading at only around 1.3X, in line with the Global Financial Crisis. Compared to its long-term average of around 2.2X, equities were initially offering a 50% discount! Prudential has taken advantage of these cheap valuations, while also being very mindful of the higher risks that have emerged for many companies. We have been careful to select high-quality companies that should be able to weather the difficult conditions ahead and deliver solid returns for our client portfolios going forward.

For example, we have had the rare opportunity to add companies like Bidcorp to the Prudential Balanced Fund. Bidcorp is a high-quality business with geographically diversified revenues, as demonstrated by its history of delivering attractive but 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 allowances in our valuations 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-

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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.

While history never repeats itself exactly, as an indication of the level of equity returns potentially on offer, the past 40-year history of the ALSI shows that in the rare times when its price/book value fell to 1.5X or below, the index subsequently went on to deliver returns of between 14.5%-46.5% p.a. over the next five years. Some of these returns have already been realised for investors who remained invested in these assets: during the April-June market recovery the FTSE/JSE Capped SWIX Index delivered a total return of 21.6%.

Turning to the Balanced 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. This positioning has contributed to the fund's returns over the past three 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 elevated risks involved. Assuming inflation averages 4.5% (the mid-point of the SARB's targeted inflation range and a high assumption in the shorter term), 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. For example, the FTSE/JSE All Bond Index has already partly rebounded between April and June, returning a total of 9.9% over the three months.

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 an attractive discount compared to SA equities. With the rand's sharp depreciation, we opted to trim our overweight position in foreign equities and add to SA equity and SA bond exposure. Still, foreign

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equities are priced to produce a real return of around 5.5% p.a. over the next five years, we believe, a very solid return that will also help lower portfolio risk.

Lastly, cash is the one SA asset class where prospective returns are now much lower, due to the 2.5% cut in interest rates by the SA Reserve Bank over the past three months. Although investors have earned good real returns on cash investments in the last three years or so, cash returns are no longer beating inflation, and this is likely to continue for the foreseeable future. So investors should consider reducing their exposure to cash where appropriate - the Prudential Balanced Fund has very little cash exposure.

Based on this positioning and the excellent valuations at which we have been able to buy a wide range of assets, we are confident investors in the Prudential Balanced Fund will benefit from very attractive prospective returns – and with much lower risk than equities – over the next five years or so. Of course these future returns won't be delivered evenly or in a straight line – investors can expect high volatility to continue as global and local conditions evolve and the impact of the Covid-19 pandemic becomes clearer for each country, including South Africa. Those who understand this and can patiently ride out the ups and downs of the market should be rewarded over time, and Prudential Balanced Fund investors will have the added advantage of careful diversification to help lower this volatility. Now more than ever balanced funds should make up the core of a long-term investment portfolio. ■

Pieter joined Prudential in 2015 as Managing Director of Prudential Unit Trusts and Head of Retail Business. In November 2019 he was appointed as Chief Client and Distribution Officer. He has 21 years of industry experience, having previously worked at another large investment manager in various senior roles. Pieter holds a B.Comm degree in Mathematics and is a qualified actuary (holding a fellowship with the Institute of Actuaries in the UK and the Actuarial Society of South Africa). He also completed a General Management Program at Harvard Business School.

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