PRUDENTIAL **INSIGHTS**

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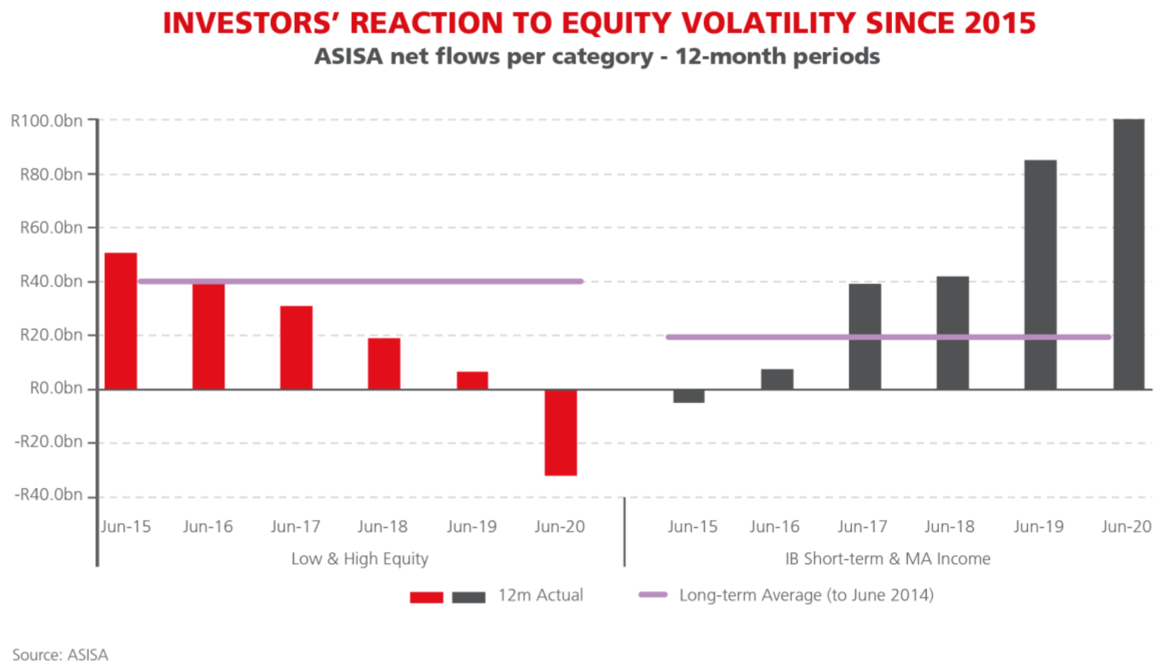
Time to reassess popular “low-risk” investments

In the wake of the weak and volatile local equity market over the past five years or so, there has been a marked change in investment preferences in South Africa: investors have been putting an ever-increasing proportion of their funds into low-risk investments and reducing their equity exposure. Yet longer-term investors should be aware of the elevated risk cash-related investments now present, in terms of both the far lower absolute level of interest rates now prevailing and the opportunity costs involved in avoiding equities.

Investor “de-risking” has been prevalent since at least 2015: money market funds and interest-bearing short-term unit trusts have been the largest beneficiaries of inflows, with multi-asset income unit trusts the third-largest recipients, ASISA statistics confirm. The second quarter of 2020 saw an acceleration in this trend as money market funds took in more than double the amount of net inflows as the second-highest category, gaining some R48 billion versus around R23 billion for interest-bearing short-term funds. Meanwhile, diversified unit trusts used traditionally for retirement or longer-term investing, like multi-asset low-equity and high-equity (balanced) funds, have experienced increasing outflows.

Graph 1 highlights this trend: low-risk fund inflows have been far above their long-term average just as multi-asset low-equity and high-equity fund inflows have dwindled into outflows.

GRAPH 1

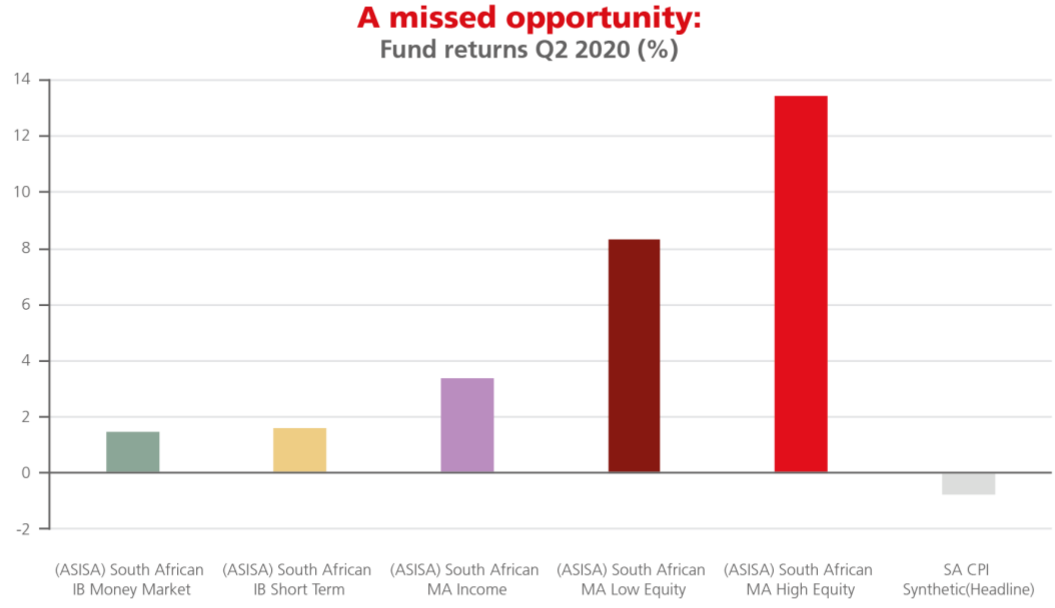


Chasing short-term performance

As we have discussed before, this trend has developed as a result of investors (and many financial advisers) chasing the latest short-term fund performance, as the environment of abnormally high interest rates combined with weak equity returns has led to relatively stronger returns from lower-risk assets: taking on higher risk with equities has not paid off. Consequently investors have shied away from exposure to higher-risk assets, and even more so in the wake of March's market sell-off following the country's shutdown as a result of the Coronavirus crisis.

Yet this short-term view has meant that investors have largely missed out on the equity rally over the second quarter of 2020, as Graph 2 illustrates: multi-asset low-equity and high-equity funds delivered average returns of over 8% and 13%, respectively. On the other hand, low-risk money market and interest-bearing short-term funds averaged returns of less than 2% for the period. And with the SA Reserve Bank having cut interest rates by a total of 3.0 percentage points so far this year, these lower-risk funds now have much poorer return prospects going forward.

GRAPH 2



Source: Morningstar

Cash-related investments now riskier

In fact, unit trusts with high cash holdings have become much riskier for longer-term investors: Prudential expects that money market funds will not beat inflation over the next three-five years. Meanwhile, South African equities are now offering excellent longer-term prospective returns based on current valuations.

Given the significant change in financial market conditions in South Africa in recent months, with interest rates being slashed to record-low levels and excellent valuations for risk assets, we would hope that investors with longer-term investment goals would consider taking advantage of this and increase their equity exposure to more appropriate levels. At Prudential we have used the opportunity to increase the SA equity exposure in many of our funds (where appropriate), such as the Prudential Balanced and Inflation Plus Funds. We expect SA equities will reward investors over time with higher-than average returns (compared to their history). Patience will be required, however, as no one knows how or when those returns will be delivered. What we do know is that for longer-term investors, cash-related and short-term investments are no longer as low-risk as they once were.

For more information on the Prudential Balanced and Inflation Plus Funds, and other solutions for longer-term investors, please visit the Our

Funds section on our website, or try our Fund Selector Tool to find out which Prudential fund is best suited for you. Alternatively, feel free to contact our Client Services Team on 0860 105 775 or email us at query@prudential.co.za.