QUARTER 04 2020

CONSIDER THIS

IS OFFSHORE REALLY WHERE IT'S AT?

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Consider this **Q4 2020**

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Letter from the CEO

Benard Fick
CHIEF EXECUTIVE

It's been over seven months now since we've been grappling with the impact of the Coronavirus pandemic, and while some global financial markets have regained their health, we can't say the same for societies. After such a lengthy period of lockdowns and social restrictions, it's not surprising that we see increasing tensions between public health and wealth concerns, amid accelerating "second waves" of the virus around the world.

Until there is a vaccine, governments are going to have to work hard to keep the public focused on managing their risks, while still being able to reap the rewards of economic activity. The unfortunate reality is that South Africa's weak domestic economy and extraordinary levels of unemployment mean that we simply cannot afford new lock-downs that restrict economic activity in any material way. Protecting public health in South

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Africa's case, and we'd argue across the world, can only be achieved by behavioural change towards continued social distancing. This is currently proving difficult in many countries across the world, as policymakers and different groupings in societies argue about the trade-off between saving lives vs livelihoods (which can be shown to translate to even more "years-of-life-lost").

This has resulted in a "tug-of-war" between caution and optimism during the third quarter (Q3) of 2020 and was reflected in continued volatility in both global and local financial markets: bearishness over higher global "second waves" of the Coronavirus pandemic offset to some extent rising optimism over the development of an effective vaccine and the economic rebounds experienced as economies exited the initial round of lockdowns. Financial markets were generally positive across both equities and bonds, helped by ongoing supportive monetary and fiscal policies, although the gains were far lower than the exceptional rallies seen in Q2.

South African financial markets underperformed their global counterparts but were marginally positive, helped by further opening of our economy under Lockdown Level 1, higher commodity prices and exceptionally low interest rates. This was despite the country posting a shocking 51% q/q contraction in GDP in Q2 2020. GDP is now expected to contract by 8.2% in 2020, before rebounding by 3.9% in 2021 and 2.6% in 2022. Over the July-September period the FTSE/JSE Capped SWIX Index returned 1.0%, the All Bond Index returned 1.5% and the Inflation-Linked Bond Index returned 1.2%, while cash (as measured by the STeFI Composite) also produced 1.2% for the three-month period.

The local equity market finished in the black thanks solely to Resources stocks, with other sectors losing ground as "SA Inc" counters came under more selling pressure. The Resources 10 Index returned 5.7%, Financials -1.6%, Industrials -2.3%, and Listed Property (SAPY Index) was the poorest performer with -14.1%.

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In the accompanying table you can see that Prudential's unit trust performance reflected these subdued asset class returns over the quarter. Positive short-term returns continue to result in a recovery of returns from the depths of the market correction in March 2020, and returns from 1 January 2020 across most funds continue to improve.

Prudential Unit Trust (all returns shown after all fees and charges, for A Class units)	3-Month Return (July-Sept 2020) Net of fees
Prudential Balanced Fund	0.6%
Prudential Dividend Maximiser Fund	0.6%
Prudential Enhanced SA Property Tracker Fund	-13.8%
Prudential Enhanced Income Fund	1.8%
Prudential Equity Fund	1.5%
Prudential High Yield Bond Fund	0.7%
Prudential Income Fund	3.1%
Prudential Inflation Plus Fund	0.2%
Prudential Global Balanced Feeder Fund	0.9%
Prudential Global Bond Feeder Fund	-1.1%
Prudential Global Equity Feeder Fund	3.0%
Prudential Global Inflation Plus Feeder Fund	-0.1%

New Prudential Property Fund

In July, we launched the Prudential Property Fund, a new unit trust designed to complement our existing Prudential Enhanced SA Property Tracker Fund. The new fund is available to institutional investors (D Class), and we plan to open it to direct retail investors (A Class) in the coming months. The new Prudential Property Fund is actively managed as a valuation-based fund using the same investment process as our successful equity unit trusts, with the SA All Property Index (ALPI) as a benchmark.

This is in contrast to our long-established Prudential Enhanced SA Property Tracker Fund, which is benchmarked against the SA Listed Property Index (SAPY, which has a narrower universe than the ALPI), uses a more quantitative investment approach and is managed to take very small positions relative to its benchmark in accordance with the "enhanced index" nature of the Fund.

Reduction in annual management fees for more Prudential funds

As you might be aware, towards the end of last year we decided to reduce the annual management fees for several of our funds. During the most recent quarter we concluded the review of our unit trust fund fees, and announced reduced fees across three further Funds where we believed we could give our clients additional benefit of our economies of scale. As a result, from 1 October we implemented fee reductions of between 0.05% and 0.15% p.a. in respect of the Prudential Enhanced Property Tracker, Prudential High Yield Bond and Prudential Money Market Funds. This brings to eight the total number of funds where we have reduced our annual management fees since December last year.

Looking Ahead

These recent times have been disappointing for all investors. As co-investors with our clients, we certainly appreciate the concern that many savers are feeling. You may rest assured that the Prudential team are consistently focussed on our client portfolios. There is increasing evidence of valuations beginning to "bite", as we can see from recent announcements of buy-outs or share buy-backs from

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companies like Afrox and Naspers. We continue to position our portfolios to take advantage of assets that are priced to deliver exceptional prospective returns.

As always, we hope you enjoy this Q4 2020 edition of Consider this, and 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

PIETER HUGO
CHIEF CLIENT AND DISTRIBUTION OFFICER

KEY TAKE-AWAYS

- *In the current bearish environment, many investors want to increase their exposure to offshore assets. However, many may already have a high percentage offshore without realising it.*
- *Currently some 59% of the earnings on the FTSE/JSE All Share Index come from outside South Africa, while the local Listed Property Index has 31% of company earnings sourced from offshore. The average SA multi-asset "Balanced" unit trust's offshore exposure, where many investors have placed their retirement funds, is over 50%. These are relatively high weightings, and offer important diversification benefits for all investors.*
- *While each individual investor has their own goals, and therefore the appropriate amount of offshore exposure will be different for everyone, it makes sense to evaluate how much you currently have and how much you ultimately need in light of those goals. It would be value-destructive to rush offshore now and put all of your funds offshore in an emotional reaction to the gloomy views in the local market.*

Q I'm considering taking more of my savings out of South Africa because I'm worried about the rand getting even weaker and SA's low growth prospects. What are some of the factors I should be thinking about in deciding what to do?

A There are many factors you need to consider when deciding if you should increase your portfolio's offshore exposure, and here I'd like to mention one that is less obvious than the typical main drivers investment managers would normally highlight (those of the valuations of local versus offshore assets and the rand). At Prudential we would suggest that it's likely be a wise move to first check what your current offshore exposure actually is – it could be higher than you think, just by already being invested in a typical South African balanced fund.

South Africa keeps globalising

It's important to remember that the FTSE/JSE All Share Index (ALSI) has globalised in the past two decades, and this trend continues. Only a year ago some 55% of the earnings from companies listed on the ALSI were sourced from outside of South Africa, and this figure now stands at 59% as the rand depreciates versus developed market currencies and companies expand further abroad in their search for profits. Also we've seen numerous foreign companies doing inward listings on the JSE, many of which had no links to South Africa before. The listed property sector is also surprisingly globalised, with 31% of the All Property Index's earnings originating offshore. That can give your JSE-listed portfolio some solid offshore diversification, depending on the companies you're exposed to. Equally, it means you are not as likely to be as negatively impacted by South Africa's current growth slump or rand depreciation as you might fear.

Graph 1 shows a selection of ALSI-listed companies with large portions of their earnings sourced from offshore. While Naspers is well known, others that may be less in the spotlight include UK-based financial services group Quilter

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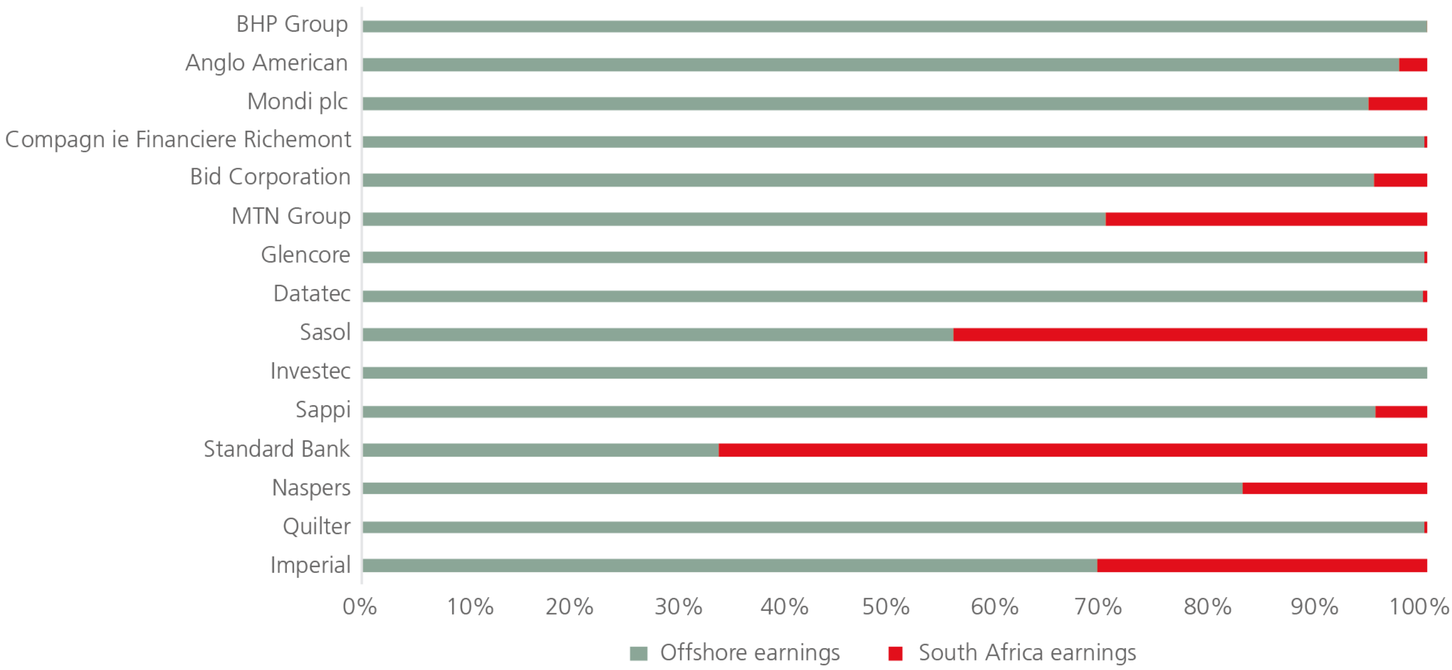
and IT specialist Datatec. And although the resources companies have long been strong rand-hedge plays (like BHP, Anglo American, Glencore, Mondi and Sappi), South Africa's industrial businesses such as Bid Corporation and Imperial have also become increasingly globally diversified. Chances are, you're already likely to be exposed to several of these companies in your existing SA portfolio given how large they are in the ALSI and their attractive diversification benefits.

Average SA Balanced Fund holding over 50% offshore exposure

And what about a typical SA "Balanced" unit trust, the most popular type of unit trust used by South Africans? We can use Morningstar data to see the asset allocation of the average unit trust in the ASISA Multi-Asset High-Equity category, and in turn get an estimate of its offshore exposure.

This is shown in Graph 2, where we find that the average SA Balanced unit trust is holding 38.2% in domestic equity

GRAPH 1: Large offshore earners listed on the ALSI



SOURCE: Factset GEOREV

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(the largest asset class weighting), followed by domestic fixed income at 26.7% and offshore equity at 21.3%. At first glance, it seems like the average Balanced unit trust has approximately 29.8% total offshore exposure.

However, because we know that around 59% of the earnings from the domestic equity category are sourced from offshore, we can deduce that the average Balanced unit trust has roughly an additional 22.6% in offshore exposure (59% of 38.2%) in its domestic equity holdings. Similarly, it is has an additional 0.7% offshore exposure through its domestic property investments' offshore revenue, but 0% offshore exposure in its domestic fixed income holdings. **Adding up the various asset classes which contain some offshore exposure, we see that the average SA Balanced unit trust has roughly 53.1% offshore exposure – over half.** This may or may not be an appropriate amount for your individual investment requirements, but it is likely to be far more than you had expected. This is particularly true given the lower direct offshore limits placed on retirement fund investments under Regulation 28 (currently a maximum

GRAPH 2: Composition of the average ASISA SA Balanced fund

Asset Class	Asset Allocation	% Offshore Exposure	Offshore Exposure
Domestic Fixed Income	26.7%	0.0%	0.0%
Domestic Property	2.4%	31.0%	0.7%
Domestic Equity	38.2%	59.0%	22.6%
Domestic Other	2.9%	0.0%	0.0%
Offshore Equity	21.3%	100.0%	21.3%
Offshore Property	0.8%	100.0%	0.8%
Offshore Fixed Interest	5.2%	100.0%	5.2%
Offshore Other	2.5%	100.0%	2.5%
	100.0%		53.1%

SOURCE: Morningstar

of 30% offshore plus an additional 10% in Africa ex South Africa).

Using the above methodology, the Prudential Balanced Fund currently has approximately 52.2% offshore exposure on this look-through basis, just slightly less than the category average. This is due to our current preference for the local equities and bonds.

The SA equity market is much cheaper than its developed market counterparts. SA equities have a weighting of 45.8% in the fund (as of 31 August 2020), with some of the largest holdings including global giants like Naspers, Prosus, British American Tobacco and Anglo American. Even with its current overweight positioning in domestic-listed equities, the fund still has over 50% of its exposure to offshore revenues.

How much offshore is enough?

Each individual investor has their own goals, investment timeframe and risks to consider when determining how much offshore exposure would be appropriate to include in their portfolio. Impacting this decision is the structure of their current assets and how they are held -- whether they are subject to the Regulation 28 restrictions. For most investors, for example, their two largest assets are their primary residence (which is 100% local) and their pension fund (constrained by Regulation 28's offshore limits). Therefore, for their other discretionary investments (outside of their pension fund) they may want to consider having more offshore exposure in order to balance their total portfolio.

The diversification benefits of offshore investments are certainly well established; not only from a return perspective but also from a risk perspective. What is most important is not to react emotionally in difficult local market conditions (or when the news and general sentiment is especially negative) and decide to take extreme measures like taking your entire portfolio offshore. Doing so now would mean that you are selling cheap South African assets and exchanging cheap rands for expensive foreign currency, and then buying expensive assets. Rather, work with an experienced financial adviser to understand what your current

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exposure actually is, and then what it should be based on your financial goals. In a separate article I'll address our views on the valuations of local versus offshore assets and what this tells us about how to position our client portfolios like the Prudential Balanced and Inflation Plus Funds. ■

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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The Merits of Investing Offshore Now

DAVID KNEE
CHIEF INVESTMENT OFFICER

KEY TAKE-AWAYS

- *In the current grim prevailing investment narrative, South African assets are doomed to underperform their offshore counterparts and the economy is set to remain weak; therefore investors need to have a large amount of their funds offshore.*
- *However, the facts show that historically the JSE has outperformed global equities over long periods. It is their more recent underperformance that is dominating the current narrative.*
- *Currently SA equities and bonds represent excellent value compared to developed country markets, offering strong prospective returns. While SA bonds do carry higher risks than in the past, Prudential does not believe that government default is likely in the near term. History shows that when*

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valuations are significantly in favour of South African assets, as they are currently, subsequent long-term returns eventually reflect this.

There is currently a narrative among some investors that holding local assets has been a disaster for South African investors, even over multi-decade periods, and that now is the time to save whatever crumbs are left and move everything into the safety of hard-currency assets. Following are some observations on this view (from an investment returns perspective) which may give investors pause for thought.

A grim view

How can this have happened? Investment theory suggests higher-risk emerging markets should deliver a risk premium over their developed peers in the longer term, albeit with a bumpier ride. But South Africa has failed to reach its growth potential, they say. While Asian markets roared ahead after the late '90s crisis, South Africa struggled to break a sweat, bar a few brief years in the mid-noughties when a commodity and credit bubble delivered a decent 5% real return only to find that it had all been borrowed from the future. The cracks emerged post the Global Financial Crisis (GFC), and over the ensuing decade they widened to chasms into which investment and consumption plans were quietly discarded and what was left staggered forward, weighed down by the millstone of widespread corruption and graft. What hope is there then for the future? The final chapter of this narrative does not see South Africa benefitting from economic absolution, a wiping clean of the slate and a period of long-awaited renewal. South African assets are doomed to underperform, companies to struggle to generate decent earnings growth, and bonds to face the inevitable march into the jaws of default.

The question is, though, is this story fact or fiction? And either way, is the outlook as pre-determined as this bleak narrative suggests? We need to be circumspect about relying on our emotions when it comes to investment decisions; human beings are poor judges of facts because our emotions colour our interpretations and recollections of the past. Recent poor experiences can receive disproportionate attention

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TABLE 1: INVESTMENT RETURNS (RAND, NO FEES, P.A.)

Period	FTSE/JSE ALSI	MSCI World	Difference
31 Dec 1996 – 31 Aug 2020	13.0%	13.1%	-0.1%
31 Aug 1999 – 31 Aug 2020	13.9%	11.0%	+2.9%
31 Mar 2009 – 31 Aug 2020	10.8%	16.6%	-5.8%

that blurs prior history. Our feeling is that things are really bad now, they must always have been like this and are therefore likely to continue forever into the future. There is no doubt South African investors have had a grim time of it more recently, but is this a full and fair exposition of history?

A great long-term investment in the past

Table 1 details the long-term investment returns of the FTSE/JSE All Share Index (ALSI) against the MSCI World Index (an index of developed market equities). From the end of 1996 until end-August 2020, the ALSI has matched the MSCI World almost exactly in rand terms. That hardly seems like a disaster, and end '96 is a fairly punitive starting point as South Africa was just about to be battered by the fallout from the 1997 Asian Crisis and the 1998 Russian default. If you roll the starting point forward to August 1999, giving 20 years of history, the ALSI has beaten the MSCI World in rand terms by 2.9% per annum over two decades, which includes the recent poor performance of the SA equity market. An initial R100 investment has become R1,570 if left to work in the South Africa equity market; the same R100 in offshore equities only R920. That is an extraordinary difference. This makes it hard to reconcile the prevailing sense of despair which accompanies holding SA assets with the fact that they have been a great long-term investment, just as theory suggests.

11 years of relative underperformance

Table 1 also shows why it is we feel so despondent. Since end-March 2009, the low point for global equities during the GFC, the MSCI World has outperformed the ALSI by 5.8% p.a. The value of R100 invested offshore during this period would have generated R630, more than double what leaving your money in South African equities has delivered. The truth then, is that it is not the long term which has been the problem, it is the past 11 years which has been a relative disaster.

In absolute terms, since the GFC South African investors have still almost tripled their money locally, but compared to offshore it feels like we've become the poor cousin. It is natural to extrapolate recent experience both forward and backward in time, following the mantra "It has always been like this and it always will be". That the facts show that South Africa has in the past offered exemplary returns should give pause for thought at the very least. Could it do so again?

SA valuations relatively cheap

Prudential approaches this question by asking what current market valuations can tell us about future prospective returns. Taking the same periods as in Table 1, Table 2 shows a common equity market valuation indicator, the Price to Book value ratio (P/B), at the start of each period.

If we correlate these valuations to the returns in Table 1, the data suggests that when the ALSI has traded at a very substantial discount to the MSCI World, subsequent long-term returns have tended to be very good. At the

TABLE 2: EQUITY VALUATIONS (PRICE TO BOOK VALUE)

	P/B AT BEGINNING OF PERIOD		
Period	FTSE/JSE ALSI	MSCI World	P/B Premium/ (discount) of FTSE/JSE ALSI relative to MSCI World
31 Dec 1996 – 31 Aug 2020	2.33	2.69	-13%
31 Aug 1999 – 31 Aug 2020	1.57	3.62	-57%
31 Mar 2009 – 31 Aug 2020	1.61	1.41	14%
Current	1.65	2.75	-40%

end of 1996, the two markets were trading on similar P/B levels and then delivered similar returns, but in late 1999, almost three years later, the ALSI had de-rated significantly to 1.57 while developed world equity markets had re-rated to a sky-high 3.62 P/B. Given this, perhaps it is not surprising that the subsequent returns over two decades massively favoured South Africa.

Today we find ourselves in a similar situation: current valuations are significantly in favour of South Africa. With a P/B of 1.65, the ALSI is offering a 40% discount compared to that of the MSCI World at 2.75. Although this isn't as extreme as late 1999, it suggests analysts already expect a far more favourable environment for developed markets, whereas a good deal of pessimism sits in South African valuations. The distribution of potential outcomes from this starting point favours South Africa.

Forecasting the future

Of course this is not a guarantee that local equities will outperform developed markets going forward, or even that returns will be high versus their history on an absolute basis. However, it certainly challenges the notion that there is nothing on offer for investors in South Africa equities. Investors can seek to justify the current ALSI valuation on the basis of poor fundamentals, a hollowing out of our industrial capacity, of institutionalised graft, of policy paralysis that prevents much needed economic transformation and reform. Remember, however, that it is more-or-less impossible to buy an asset with a good story at a cheap price, and recognise that the narrative now has to change from "SA equities have always been rubbish" to one where it is understood that they have done well long-term but now one has formed a view that this history isn't going to repeat. Then ask: "How hard do I want to back my view of the future relative to anyone else's; why do I think I am better at forecasting the future than the market?" Placing all your eggs into the hard currency basket, against what the valuations suggest and on the back of a view, is a big call.

What about SA bonds?

OK. But clients don't just own equities. Most investors own balanced funds, multi-asset products. A separate line of attack might suggest that while SA

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TABLE 3: 60:40 BALANCED FUND RETURNS

Period	South Africa	Offshore	Difference
31 Dec 1996 – 31 Aug 2020	12.9%	11.9%	+1.0%
31 Aug 1999 – 31 Aug 2020	13.1%	10.4%	+2.7%
31 Mar 2009 – 31 Aug 2020	11.1%	14.3%	-3.2%

equities have done well over the long term, SA bonds can't have been a great investment. Look at current yields, with 20-year government bonds at over 11% when their US equivalents are barely over 1%. Table 3 shows returns for a 60:40 equities:bonds balanced fund in South Africa and offshore. The SA portfolio uses the FTSE/JSE All Share and All Bond Indices, while offshore we look at the MSCI World and World Government Bond Indices.

Even when we incorporate bonds into a portfolio, the history is much the same. Investors in a domestic South African balanced fund have done well over the past two decades, despite the precipitous fall in global bond yields. However, as with equities, the post-GFC period has been relatively poor for South African bonds, and we would suggest that this leaves investors determined to avoid repeating this past decade in the decade to come -- irrespective of the attractive valuation signal at hand.

We have seen that SA equity valuations appear to favour the performance of

TABLE 4: REAL BOND YIELDS

	SA 10yr Yields	World Gov Yields	Difference
31 Dec 1996	7.6%	2.6%	5.0%
31 Aug 1999	8.6%	2.6%	6.0%
31 Mar 2009	-0.1%	0.4%	-0.5%
Current	5.7%	-1.2%	6.9%

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the local market against its developed peers going forward, but is this also true for SA bonds? The classic indicator is the inflation-adjusted yield. We have used the average inflation rate over the previous three years as a proxy for market expectations at each valuation point.

Is near-term government default likely?

As Table 4 highlights, the current difference between South African real 10-year government bond real yields and their global peers is a substantial 6.9% – higher than it was in either 1996 or 1999 – and very attractive by comparison. High nominal yields in SA combined with falling inflation have increased real yields on offer. In global markets, while inflation is very low it remains in positive territory and nominal yields are close to zero, leading to negative real yields. From this starting point only a view of a near-term default by South Africa would undermine the valuation advantage.

This is not impossible, but the absence of significant quantities of foreign-denominated debt leaves South Africa as a non-traditional candidate for default. SA also has well-developed domestic financial markets unlike most emerging markets, with a substantial private sector savings industry, creating potential 'self-help' levers that are available to postpone default for a considerable period and/or avoid it altogether, even if National Treasury doesn't manage to achieve its full fiscal consolidation objectives.

Rand weakness favours local investing

A final factor to consider in the "offshore or bust" argument is the current valuation of the rand. Since the start of the Coronavirus crisis in March, the rand, along with its emerging market peers, has depreciated significantly against the major global currencies as investor sentiment turned extremely risk averse and as local conditions deteriorated. Since then, notwithstanding more recent US dollar weakness, it has remained undervalued as measured by its purchasing power parity compared to history. This would suggest the rand would be likely to appreciate against the major global currencies from current levels, thereby eroding offshore returns in rand terms. Equally, buying offshore assets

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now with undervalued rands is like waiting until prices rise to buy the latest smartphone.

In conclusion, history suggests that when valuations are significantly in favour of South African assets, subsequent long-term returns eventually reflect this. This is generally true for assets globally, not just in our own case. It is certainly erroneous to think that investing in domestic bond and equity markets has always been a losing strategy. The implementation of a view premised on this thought ignores prevailing valuations which across asset classes suggest there is a high probability that favouring offshore markets at this point will eventually prove to be a value-destroying trade.

In light of the above considerations, but especially the current valuation signals, Prudential's house view portfolios are underweight offshore equities and bonds compared to our peers. We are instead overweight high-quality, well-valued SA stocks and long-dated government bond that we expect will deliver superior returns over the next five years. ■

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.

iStock-936418814

PGMs shine in lacklustre SA equity market

Aeysha Samsodien
EQUITY ANALYST

KEY TAKE-AWAYS

- *Although the price of platinum has been declining or largely flat, the US$ prices of palladium and rhodium have been rising strongly in the past two years. Demand has been growing in line with the impending imposition of higher global vehicle emission standards, with supply unable to keep up.*
- *The weakening rand versus the US$ has added to the rand-based revenues of South Africa's PGM miners. Also, within the PGM sector, company restructuring and cost-cutting have helped expand margins and profits such that they are now at very high levels on an historic basis. Consequently, PGM miners' share prices have eclipsed the FTSE/JSE ALSI in the past two years.*
- *The risks of falling PGM prices, company margins and revenues going forward are relatively elevated. Combined with the prospect of rand appreciation, this makes*

us cautious about prospective earnings for PGM mining companies. However, this is balanced by a fundamental demand underpin, making us neutral on the sector in our best-view portfolios.

Platinum Group Metals or "PGM" stocks have been among the few standout performers in the local equity market in the last two years, delivering returns that have easily eclipsed those in most other sectors. Here we examine the factors behind this outperformance and the complexities in the PGM market, as well as Prudential's investment views on the South African PGM miners. We also go "back to basics" for those who want to know more about the sector, which plays such an important role in the South African economy.

PGMs not just about platinum

Although platinum, and more recently palladium and rhodium, generally dominate commentary on the sector, PGMs is in fact a group of six silvery-white metals that are chemically, physically and anatomically similar: platinum, palladium, rhodium, ruthenium, osmium and iridium. They have chemical and physical properties that make them good raw materials and catalysts within manufacturing processes. For example, platinum, palladium and rhodium have excellent catalytic uses, as they are resistant to oxidation and high-temperature corrosion, and are the three PGM metals most in use around the world. Some 67% of these "3E" (E for Element) PGMs, as they are called, is used for auto-catalysts in the exhaust system of automobiles, 12% for jewelry and 20% for other industrial uses. Consequently, apart from their supply, global auto sales and changing auto emissions standards are the key drivers of the PGM basket price, and this price is dominated by the 3E PGMs. It is no coincidence that the world's top auto producers - the US, Western Europe and China - are also the largest consumers of PGMs.

The six metals occur together in nature alongside nickel and copper in reef-type ore bodies in only few places in the world: the Bushveld Igneous Complex in South Africa, the Great Dyke in Zimbabwe, Northern America and Russia. The type of PGM reef determines the percentage of the six metals that are present within the ore body, the most predominant being platinum, palladium and rhodium.

South Africa is among the world's largest producers of PGMs, mining 72% of the global primary supply of platinum, 35% of palladium and 80% of rhodium. The Bushveld complex, discovered in 1924, contains three types of ore bodies: Merensky, which comprises on average 63% platinum, 28% palladium and 5% rhodium ; UG2 (57% platinum, 31% palladium and 11% rhodium on average); and Platreef (44% platinum, 47% palladium and 3% rhodium on average).

The ore bodies found in Russia and Northern America are more palladium-rich, with the latter usually comprising 78% palladium and 22% platinum. In Russia, meanwhile, the bulk of the PGM supply comes from Norilsk Nickel's operations, where palladium is a by-product of its nickel mining and is 32% of production.

What is an auto-catalyst?

An auto-catalyst is a solution of chemicals and a combination of the 3E PGM metals within a cylinder made from ceramic or metal, which forms part of the catalytic system of an internal combustion engine. It converts the pollutants released from the combustion of fuel (such as carbon monoxide and nitrogen oxide) into harmless gas. This is particularly important in the concerted global effort to address climate change, as the 3E metals are an essential element to ensure vehicles meet rising emission standards. "Loadings" refer to the amount of 3E metal that is found in an auto-catalyst, where there can be between 3-7 grams per auto-catalyst. The proportion of 3E metals required is dependent on the engine type: in gasoline/petrol engines auto-catalysts are made of a majority of palladium, while diesel engine auto-catalysts are platinum-dominant. "Thrifting", meanwhile, is a process that reduces the loadings in an auto-catalyst, while still maintaining efficiency: the auto-catalyst is able to maintain its required technical capabilities.

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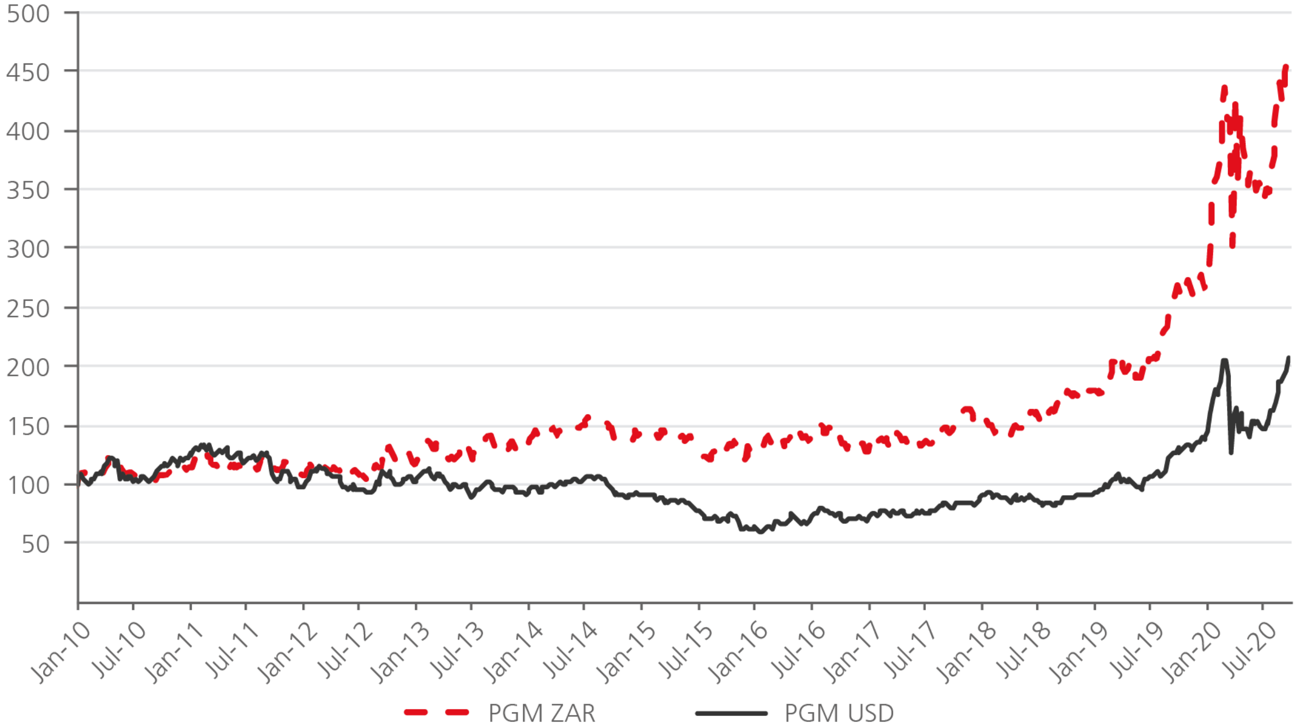
What's been happening in the PGM market?

The PGM sector on the JSE (the FTSE/ JSE Platinum Index) comprises Anglo American Platinum, Impala Platinum, Sibanye Stillwater, Northam Platinum and Royal Bafokeng Platinum. Consolidation in 2019 saw Sibanye Stillwater acquire Lonmin, making it the one of the largest PGM producers and South Africa's largest private sector employer.

Graph1 depicts the price history of the PGM basket of metals from just after the Global Financial Crisis in 2009 to August 2020, where we can see that the price in both US dollars and rands rose steadily from the unsustainably low levels it reached at the time and was well supported until 2013. The increase was driven by strong growth in the global car fleet, which offset increases in thrifting from car manufacturers over the period.

Graph 1: Price of 3E PGM Basket has taken off since 2018

Indexed to 100



SOURCE: Inet Data

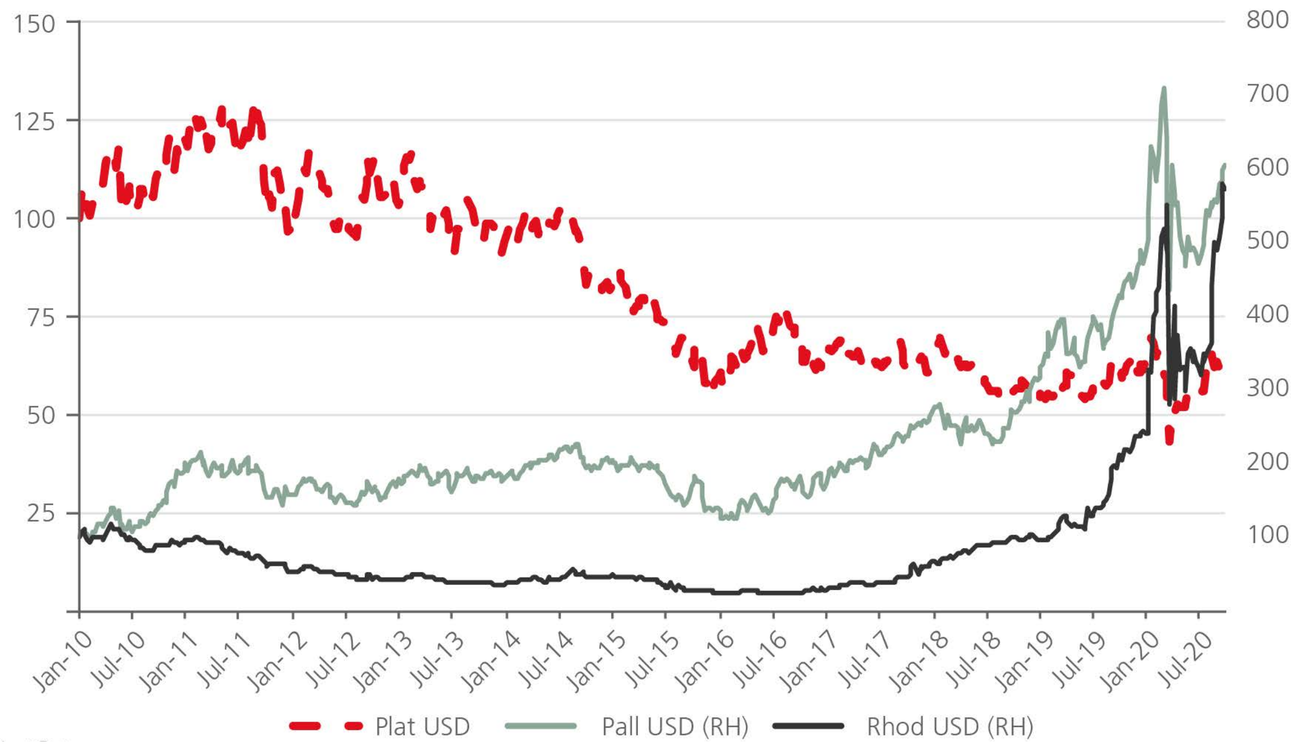
While this boosted the revenues of PGM miners, the gains in their profit margins were eroded by rapidly rising mining inflation due to above-CPI wage increases for mine workers.

Then from 2013, we can see that despite the dollar basket price declining, the weakening rand helped the overall rand PGM basket price remain relatively stable. However, mining inflation continued to accelerate on the back of ongoing above-inflation wage increases in the sector and decreasing productivity rates across the South African mines, specifically the deep-level conventional mines, where costs continued to escalate. This put overall pressure on the profitability of the miners. In response, the companies attempted to address their higher cost bases through restructuring. For example, Anglo American Platinum was one of the first to start reducing costs: as early as 2013 they began restructuring their Rustenburg assets, which they subsequently sold to Sibanye Stillwater. This early intervention benefitted them relative to the other producers. Meanwhile, Impala Platinum, which was especially impacted by low productivity rates, started a process to restructure their high-cost Impala Lease operations during 2018, but the delay proved to be costly for the company.

Another negative impact on the industry stemmed from the well-publicised "Diesel-Gate" scandal at Volkswagen in 2015, where investigations found that VW had installed software in its diesel car engines that enabled it to cheat on emission standards. This led to the German automaker facing numerous regulatory investigations and lawsuits - it is estimated that the scandal has cost the company some US$35 billion in fines and settlements as at 2020. Subsequently, with diesel cars falling out of favour it was found that this acted as a drag on platinum demand from European car manufacturers, in turn weighing on the platinum price. These conditions have persisted, with the US dollar platinum price continuing to move largely sideways in recent years, as shown in Graph 2.

Conversely, the prices of palladium and rhodium started to rise from 2018, supporting the overall PGM basket price. This trend has also continued until the present, apart from the brief but sharp fall during the height of the market panic caused by the

Graph 2: Platinum price stalls as palladium and rhodium accelerate



SOURCE: Inet Data

Coronavirus pandemic. The rising demand has occurred in anticipation of the implementation of more stringent emission regulations -- mainly from China and Europe -- as the more stringent standards require loadings to increase within auto-catalysts. With supply unable to keep up with demand, both the palladium and rhodium markets experienced deficits in 2018 and 2019, driving their prices significantly higher. In turn, this has helped improve the profitability and cash flow generation of the South African miners.

Platinum sector far outperforms FTSE/JSE ALSI

The JSE's platinum sector has eclipsed the performance of the FTSE/JSE All Share Index (ALSI) for the last two years, returning 383% compared to the ALSI's 1.2% between August 2018 and August 2020, as shown in Graph 3. The grey line depicts the difference between the two indices, shown by

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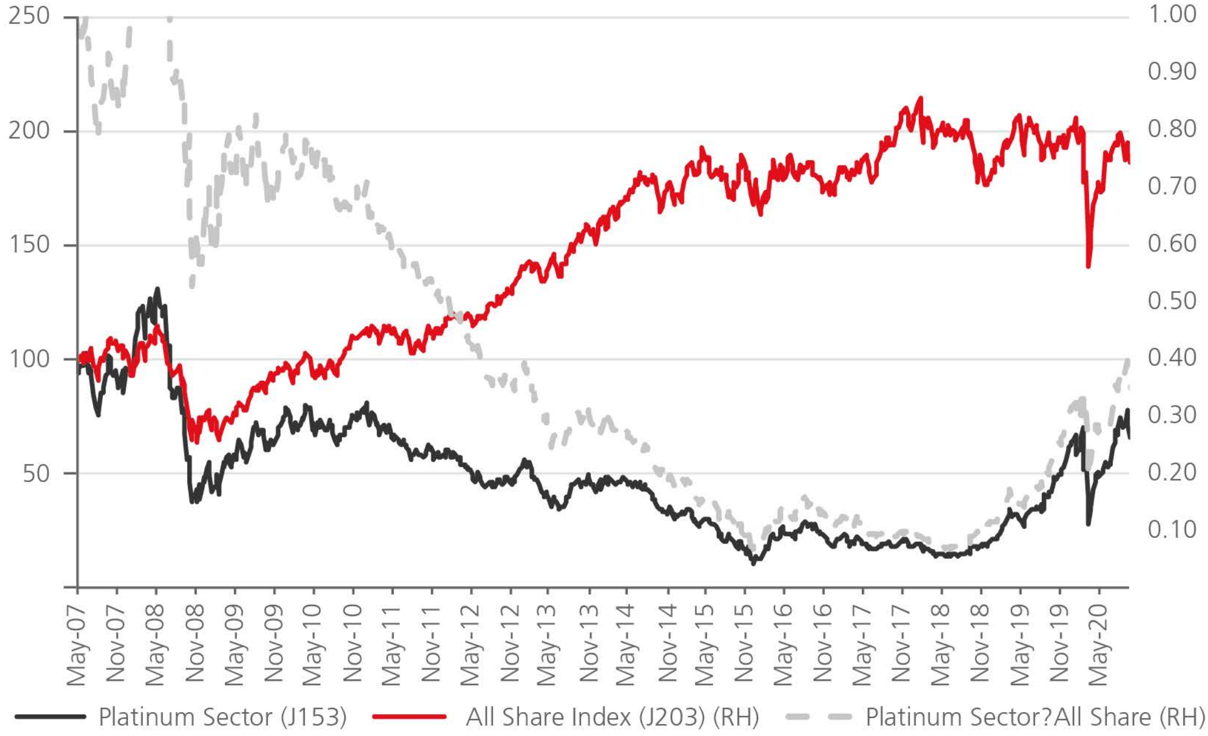
its upward and steepening movement over the period. It even recovered more quickly from the March market crash than the local equity market as a whole. Apart from the surge in the palladium and rhodium prices in US dollars, another key driver of the superior returns has been the weakening rand. Because local miners' costs are incurred in rands but they earn their revenues in US dollars, they have experienced higher profits simply due to the currency differential. They have been able to use these higher profits and cash generation to de-lever their balance sheets. Company profit margins also had some support from having undertaken cost-reduction exercises and restructuring in previous years, but the key driver was the higher commodity prices. The improved margins and profitability have in turn been reflected in stronger balance sheets and therefore higher share prices.

Graph 3: FTSE/JSE Platinum sector far outperforms All Share Index

Total returns indexed to 100



SOURCE: Inet Data

Impact of the pandemic shutdown and looking forward

The arrival of the Coronavirus pandemic in 2020 and the accompanying economic shutdowns globally have had a fundamental impact on both the demand and supply of PGMs. On the demand side, from March global car sales fell materially, and the expectation is that these sales will only return to their 2019 levels in 2023. According to IHS Auto Data, global light-duty vehicles sales totalled approximately 86 million vehicles in 2019 and are expected to fall to 70 million vehicles in 2020, an 18.6% drop.

On the supply side, during March 2020 the South African government put into place a lockdown that placed the mines on care and maintenance, reducing the expected global supply of PGM for the year.

Despite the disruptions caused by the pandemic, the PGM basket has maintained a strong price following the initial pressure in March, supported by the palladium and rhodium prices and the weak rand. The impact of these supply and demand disruptions could cause the palladium and rhodium markets to be in deficit during 2020.

The short- to medium-term outlook for the markets is dependent on the recovery of the South African supply back to 100% capacity, improving global car sales over the next few years, and increased loadings in auto-catalysts due to tighter emission standards.

Platinum, meanwhile, could benefit from substitution, as work is being done to substitute platinum into auto catalysts from palladium. The overall view is that palladium will still experience a deficit market, but the surplus market in platinum is likely to ease somewhat. Both should be supportive of PGM prices going forward.

Over the longer term, the move to electrification (Battery Electric Vehicles or "BEVs") may cause a structural demand shift as this will decrease the demand for 3E PGMs. We can see this in the capital allocation decisions currently being made by the large miners, in that they are hesitant to take on longer-term capital investment at this point. Examples include Impala Platinum's investment into Waterberg and Anglo American Platinum for Mogalakwena's expansion. If BEVs take longer than expected and miners do not invest in new supply, this may extend the PGM bull market for longer.

While pressure from climate change and the repercussions of the pandemic could accelerate the move to electrification, there are also green shoots for the industry. Hybrid vehicle models require 3E metals within their engines, and due to the increasing concern around climate change more focus is being placed on the hydrogen economy. Over the long term, the hydrogen economy will be positive for the PGM industry, enabling the use of hydrogen as a low-carbon fuel source, but this will take time. For now the research and development spending of auto manufacturers is skewed towards BEVs.

The factors underpinning the PGM sector currently are that there is still positive earnings momentum, and near-term company valuations are not overly stretched at prevailing prices. The miners are well positioned, with high margins, good free cash flow and strong balance sheets - this should underpin good cash returns to shareholders in the prevailing price environment.

Meanwhile, the risks to the sector are that company margins are elevated and there is limited cost support, as the current PGM basket is trading significantly above the miners' unit production costs. Given the current uncertainty around the demand for 3E PGMs, if this comes under pressure due to – for example, worse-than-expected repercussions on global auto sales from the pandemic and earlier adoption of BEV's – the current PGM basket price will fall. Another risk is that of rising inflationary pressure, based on miners' historic performance and management guidance from the current results season.

Prudential's PGM positioning

Across our general equity funds we have exposure to various PGM miners, and are currently maintaining a roughly neutral position in the sector. While we maintain that there is a fundamental underpin in the PGM basket price from increased loadings, current 3E basket prices are elevated and we are concerned that they will come under pressure.

Within our PGM exposure, we have an overweight holding in Impala Platinum.

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We prefer it to other platinum miners due to its relative valuation. The share has been among the strongest contributors to performance in the Prudential Balanced and Inflation Plus Funds in recent periods. ■

Aeysha joined Prudential as an Equity Analyst in April 2013 and is currently responsible for conducting research on the Mining sector. With seven years of industry experience, Aeysha spent the first three years of her career completing her articles at PwC prior to joining Prudential. She holds a Bachelor of Commerce degree in Financial Accounting from the University of Cape Town and is a qualified Chartered Accountant (SA).

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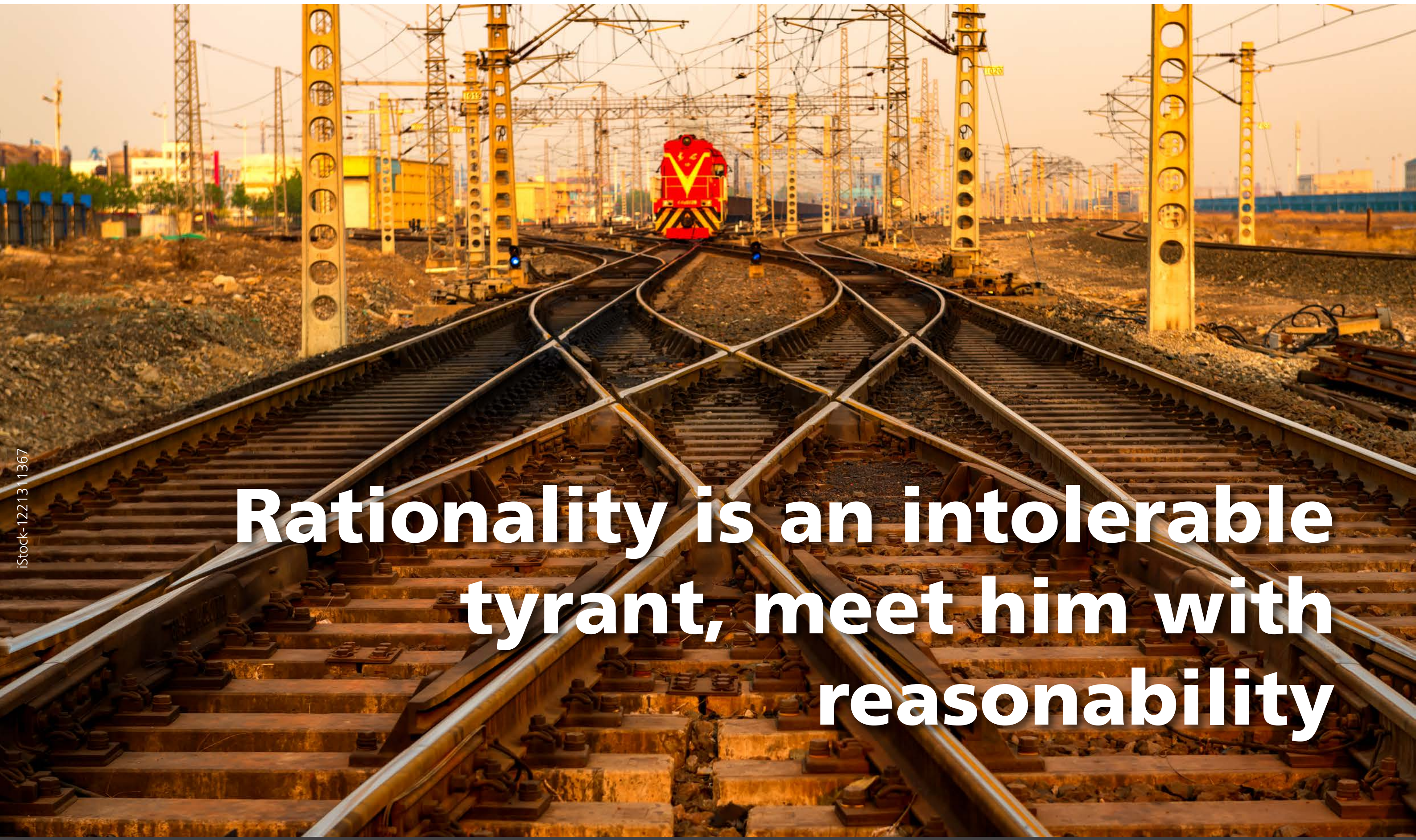

Rationality is an intolerable tyrant, meet him with reasonability

Aadil Omar
HEAD OF EQUITY RESEARCH

KEY TAKE-AWAYS

- *In an uncertain world where human biases are prevalent in decision-making, people often attempt to compensate for their known biases by striving for perfect rationality.*
- *It helps to recognize that consistently making 100% rational decisions in fields where outcomes are influenced by human emotions (like investing, rather than science or math) is nearly impossible. It is best to be reasonable about this and put in place methodologies to help reduce your degree of irrationality, rather than being intolerant.*
- *Some approaches to assist with this include: delaying your judgement on an issue (or not immediately accepting your intuition); seeking out and listening*

to a dissenting voice; and building algorithms for decision-making where possible.

Some years ago, I heard an investment professional argue in favour of his emotional nature. He claimed being somewhat emotional made him a better investor than those who are more stoic and emotionally resolute. His argument ran along the following lines: a person more attuned to his emotional side has a better understanding of self and can see traits in others that might be missed by those less emotionally aware. Specifically, he sighted an acute awareness of body language and communication style that made him a particularly good judge of character. These traits enabled him to spot fraudulent management teams well ahead of the rest of the market. It also helped him identify hard-working and sincere colleagues.

The error in his logic lies in plain sight – he confused his emotional nature and personal preferences for emotional intelligence. Needless to add, the strengths he identified did not prove particularly helpful in generating superior investment returns.

The above tale is amusing given all we now know about the biases and error-laden judgements human beings are prone to. The list of behavioural biases afflicting the human psyche already seems endless, yet the corpus of literature detailing peculiarities of perception (responsible for misjudgements) grows ever more voluminous. For instance, from the anecdote above we can identify a number of common biases: *fundamental attribution error* (also known as the halo effect, the tendency to believe being proficient in one domain translates to being proficient in a number of others); *the endowment effect* (because you possess a skill, the skill is more valuable than other skills); *confirmation bias* (citing specific examples to reinforce your view); and *blindness to context* (failure to recognise that the skills/attributes you possess might have little bearing on the objectives you're trying to meet). This list is nowhere near exhaustive and still the errors feel numerous for such a common tale.

Rationality the tyrant

It is easy to identify and criticise the irrationality in others. In fact, rationality signalling (a term we just coined referring to the tendency people have of pointing out the irrationality of others) seems to have become a popular pastime. We seem to treat rationality as an on/off switch that people can summon at will, provided they know enough about the subject matter and we're there to point out how susceptible to error they are.

The remarkable thing is that we commit similar errors of judgement in thinking that the biases do not apply to us – or at least apply to a lesser extent than they do to others who know less about the subject matter. The ambition (for both ourselves and others) of a Mr Spock-like[1] practitioner of perfect rationality might simply be indulgent. Perhaps being more *reasonable* is a better course of action.

Markowitz was a reasonable man

Harry Markowitz, Nobel Prize winner and father of the Capital Market Efficient Frontier, a crucial underpinning to the development of the Capital Asset Pricing Model (CAPM), was once asked how he invested his own money. He responded:

"I visualised my grief if the stock market went way up and I wasn't in it – or if it went down and I was completely in it. My intention was to minimise my future regret. So I split my portfolio 50/50 between equities and bonds."

Being rational and being reasonable are often not the same thing. Markowitz understood the distinction. Although the Efficient Frontier was mathematically sound and logically consistent, Markowitz understood that his humanity would likely get in the way. His ability to maintain an uninterrupted adherence to the theoretical constructs of his prize-winning theory would have been a herculean task in the face of emotional pain when the market went against him. It is one thing to understand what you should do as a rational actor before the fact, but it's completely different when the fire of the moment has you in its grip.

Learning to be reasonable

Knowledge and even the awareness of our biases do not automatically grant us discretion over them; in as much as a diagnosis of some chronic condition,

[1]Star Trek's Mr. Spock is often cited as the exemplar of logic and rationality . Alternate character assessments, however, view him as a "straw man" of rationality used to show (incorrectly) that human emotion and irrationality are better than logic.

diabetes for example, is not a panacea. Being diagnosed as a diabetic will not enable you to instruct your pancreas to start producing the requisite levels of insulin for metabolism. Knowledge and awareness are, however, useful in formulating plans to act reasonably within the constraints of our environment. A diabetic with knowledge of his diagnosis can arm himself with synthetic insulin and make conscious adaptations to diet and lifestyle to offset the impact of the disease. Likewise, being aware of our biases empowers us to anticipate the moments when we're most likely to fall victim to misjudgements and build in contingencies. It allows us to make environmental alterations that facilitate more unbiased and rational decisions.

Daniel Kahneman, the foremost authority in the field of behavioural finance and author of the best-selling book, "Thinking Fast and Slow", offers up a number of suggestions for being more reasonable when approaching rationality. Here are a few we thought worth sharing:

Delay your intuitions: It is often easier to arrive at broad truths in domains that exist outside of human influence, like physics or chemistry. The laws governing these domains do not change on the whim of the participants experiencing them. But domains wherein participants both experience and impact the environment, like financial markets or economies, embed greater degrees of uncertainty. These environments are more dynamic and the rules governing them are more likely to change. We can only really know what the rules were in hindsight. The truth we seek in these domains has less to do with an objective reality; it is more about understanding what the competing views are and what these views might be informed by. It is challenging to understand the extent of the complexity in the world we live in, but in delaying our judgements/ intuitions, we have a better chance of constructing a more complete picture.

Seek out and listen to the dissenting voice: Many of the biases we face emanate from snap judgements drawn from processing the most readily available information. This information interacts with our beliefs and we draw judgements. If we hold beliefs that are not applicable to the circumstances or draw on incomplete information (we frequently have a combination of these), we risk drawing incorrect or partially incorrect conclusions. Seeking out the dissenting voice means listening to those who have different beliefs to our own, or those who might have different information – a most uncomfortable task indeed if you're not used to it. But having a more complete picture, including the views we do not agree with, enhances our understanding of given circumstances.

Build algorithms for decisions where possible: We're often most susceptible to misjudgements in the fire of the moment or when our decision-making budget has been exhausted. However, we can set rules in calmer, more considered times when we're free from the demands of a burning issue. These rules could range from where you place your keys every evening when you return home, to automating a monthly contribution for retirement planning.

Being rational is a mammoth task, and being rational in the heat of the moment is nearly intolerable; but we can confront the struggle through reasonable preparation. Implementing and adhering to rules that prevent the possibility of ruin; building out diverse teams with varied perspectives; and making room for the dissenting voice are some of the things we can do when building portfolios. These measures cannot be simply rote in execution. They must be accompanied by a deliberate and conscious effort to improve decision making while guarding against the temptation to slip into habit.

What we can learn from the irrationality around us is not how to be rational, but rather that we are all irrational (in some circumstances). Preparing for the moments when irrationality will inevitably find us is the good fight, and reasonability is what we should aim for. ■

With 14 years' investment experience, Aadil joined Prudential in July 2013 as an Equity Analyst. In August 2018 he joined a global equity hedge fund in London, before returning to Prudential in January 2020 as Head of Equity Research and joint-Portfolio Manager of the Prudential Equity Fund. He holds a BCom degree (Hons, cum laude) from the University of Pretoria and a Masters in Finance degree from INSEAD. He is also a CFA charterholder.

ESG Investing: Putting philosophy and process into practice

Anthony Walker
ESG SPECIALIST

Aadil Omar
HEAD OF EQUITY RESEARCH

Watch webinar here

Anthony Walker
ESG SPECIALIST

KEY TAKE-AWAYS

- *Although analysing ESG factors can be complex, at Prudential the process does not involve elaborate formulas or reams of third-party data. Rather, the analysis is often not mathematically quantifiable, instead relying on a subjective call by the expert investment analyst supported by the team. ESG integration is understanding the risks and opportunities around the valuation of a particular stock associated with ESG factors.*
- *We strongly believe the analyst of every stock has to be an expert on the material ESG issues that bear on their companies, rather than using an outside third party.*
- *For Prudential, ESG is not about the exclusion of certain stocks or sectors in a "negative screening" that reduces the investment universe.*

The integration of environmental, social and governance (ESG) concerns into an investment manager's process of building and managing a portfolio is not a common topic. This can leave two misconceptions among investors. The first is that this is because it is highly complex and technical, making it a "black box". The second is that it is either a special "screen" upfront, or more cynically, an after-thought garnish or "green wash" check once the investment process is complete. For Prudential this is certainly not the case. Here we share our approach to ESG investing.

ESG integration is not new

Before delving into Prudential's ESG integration and removing these misconceptions, it should be highlighted that ESG integration is less mysterious, and more common, widespread and long- standing than one might imagine. Whether conscious of the label or not, serious long-term investors have always been alive to the material impacts ESG factors can have on the value of particular assets, irrespective of their source. More recently, ESG, Responsible Investing (RI), Sustainable Development Goals (SDGs) and the accompanying alphabet soups of principles and codes have helped refine and articulate some concerns and categorise them. By way of example, however, badly run ventures with shocking oversight, or terrible and oppressive staff policies, have always raised red flags for investors going back centuries. Other factors, such as climate change, are either new or have become more important in recent decades, but if it is something that affects the valuation or income stream of an asset, it is guaranteed to have been given consideration by a professional investment manager. Prudential has been including ESG factors in our investment process since our inception.

The black box

Can ESG integration into the investment process become highly complex? Absolutely. These days third-party data providers will provide ESG-related categorisations and risk levels on granular or collective levels, and data can be sliced and diced to a huge number of variations, and overlaid onto portfolios with heat maps, risk ratings, weightings, and any other approach that can be imagined.

Can this information be useful? Yes, it can provide flags for areas that might have been missed, and for monitoring purposes.

But do investment managers like us use these extensively in our investment analysis? No, because unlike the perfect, accurate summary a flight deck of instruments provides on an aircraft, these measures come with certain problems. These include:

1. ESG risks are not typically mathematically quantifiable. Carbon taxes are easy to ascertain over the short term, but most ESG issues are far less certain. For example, it is impossible to, with any degree of certainty, quantify how a collection of diverse governance failures can be accounted for in a mathematical valuation model. Very few ESG issues can be distilled to a number with any degree of certainty

2. Ultimately, the call on the risk or opportunity is subjective.

Much of this boils down to a matrix of criteria a company must fulfil -- for example how many times the audit committee met that year, attendance at committee meetings, and the existence of a policy on X or Y factor on the corporate website. While a company might comply with these criteria, there may be no insight into the quality of those meetings or the application of that policy. We know of a few failed SA corporates that ticked many boxes on committees and oversight. If the overall quality is poor, this can become a material risk that may get diluted or overlooked within a company's overall ESG assessment.

So who would one like analysing these risks? A black-box approach of formulas? No doubt it is best left with the dedicated investment analyst working closely with colleagues and with the portfolio managers, engaging and debating the merits and risks of each aspect of the company, the engagements required with management, the independent information required, etc.

This is not to say ESG databases and matrices provided by third parties are without use, provided they are up to date and relevant.

This is why the analyst of every stock has to be an expert on the material ESG issues that bear on their companies.

It is the analyst who has met with management over the years who must highlight to the investment team that, for example, the collective culture of a listed company, or perhaps the dominance of a founding member of the firm, is becoming a material concern. It is the portfolio managers who have listened to and interrogated that analyst in the investment team meetings who will then have a shared view on the sustainability, structural integrity and culture of that firm.

ESG is not screening

Many funds on offer in South Africa are labelled ESG funds because they do upfront screening -- certain companies are automatically excluded from the investment universe due to specific characteristics or a lack thereof (also called negative screening).

Interestingly, the United Nations Principles for Responsible Investing (UNPRI) defines ESG integration as: "the explicit and systematic inclusion of ESG issues in investment analysis and investment decisions." It is also states that "It does not mean that….. certain sectors, countries, and companies are prohibited from investing".

For Prudential, ESG is not about the exclusion of certain stocks or sectors. ESG integration is understanding the risks and opportunities around the valuation of a particular stock associated with ESG factors.

Negative screening is not an ESG-related objective analysis, but rather a subjective and personal moral call on the scope of the investment universe. This can be a very good thing on a personal level, and it may mitigate some risks, but investors must understand what the asset manager is doing in this space and what this means for them. We do screen for certain risks for our clients on request, but clients must understand the implications of this process, which in the South African equity market can massively shift the investment universe and have severe consequences on diversification benefits, while also bringing other risks.

Most critically, screening is not just about removing risk, it also entails removing ESG opportunities. It assumes that all ESG is about risk management. To the contrary, ESG is understanding and evaluating opportunities. Markets misread ESG risks as much as they misread any other risk. For example, if one of Prudential's analysts has a close relationship of information-sharing and engagement with a precious metals miner who has excellent relations with the community and staff, and who is very responsible in mitigating and managing environmental risks, and is striving to achieve cleaner energy, Prudential may require a lower risk premium for investing in that company than the general market requires.

Screening is also not a silver bullet. A bank may not be negatively screened based on its industry, yet it may be funding projects that are displacing communities and placing environments at risk, it may be harbouring corrupt executives, and the bank itself may be at risk of regulatory fines both locally and abroad.

ESG integration is not a "bolt on" process

Prudential has always believed ESG must be woven entirely through an investment manager's process, from the investment analysis, to the presentations and debates with teams, to influencing voting on the stock, and guiding portfolio construction. Finally, it must be part of the continuing monitoring and review of a portfolio. It is part of our investment DNA. The danger of adding ESG as a separate component from an outside source or team is highlighted above. On this note, we held Steinhoff at maximum underweight in our portfolios for many years, and we avoided African Bank equity, not because the companies had failed to "tick boxes" in a matrix on audit policy, attendance, meetings, or the independence of committee members. One can fool matrices and black boxes, and even those with some knowledge of a company can be duped by policies, superficial disclosure and apparently well-intended management. For us we were able to see the red flags thanks to our investment analysts who live and breathe the stock, who see the committee meetings but still have the deep concern that the picture is somehow not complete.

In conclusion, for Prudential our approach to ESG investing is not about the up-front negative screening of an asset, or a bolt-on process by a third party or non-team member. Each of these approaches does have its place, but for us, most effective form of

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ESG investing is the full integration of these factors through the entire investment process, as part of our DNA. This is shown in the diagram, where each of the five steps in our process incorporates the consideration of ESG factors, along with myriad others that go into analysing an asset and building client portfolios. ■

Anthony joined Prudential in 2007 Institutional Client Manager and in March 2019 was appointed as an Environmental Social Governance (ESG) specialist. He is primarily responsible for Prudential's ESG reporting and related work, including annual reporting to the United Nations Principles for Responsible Investment (UNPRI) and recording Prudential's ESG-related company engagements. Prior to joining Prudential, Anthony worked as an attorney and an Employee Benefits consultant. He holds a Bachelor of Commerce degree in Law and a postgraduate LLB degree from Stellenbosch University.

With 14 years' investment experience, Aadil joined Prudential in July 2013 as an Equity Analyst. In August 2018 he joined a global equity hedge fund in London, before returning to Prudential in January 2020 as Head of Equity Research and joint-Portfolio Manager of the Prudential Equity Fund. He holds a BCom degree (Hons, cum laude) from the University of Pretoria and a Masters in Finance degree from INSEAD. He is also a CFA charterholder.

iStock-87163206

Property investing: Going direct or listed?

Yusuf Mowlana
PORTFOLIO MANAGER

KEY TAKE-AWAYS

- *A decision to invest in a buy-to-let residence for income purposes means you may be missing out on potentially superior returns in the listed market.*
- *Compared to a listed property investment where a property company could own dozens of different types of buildings and sources of income in various countries, an investment in one building offers poor diversification for a portfolio.*
- *Hidden costs can eat significantly into the returns of direct property investors who have not weighed up all the risks.*
- *Consider the three L's: leverage, liquidity and lawyers, all of which can be costly if not managed correctly in both the direct and listed markets.*

For first-time or even seasoned property investors, the answer to whether it is better to invest in direct (or physical property) as opposed to a share in a listed property company (or companies) on the stock market is not unequivocal. At the very least there are several differences which need to be considered independently and in conjunction with each other to assess what is best for the ultimate investor.

The most common option for the man-on-the-street in South Africa who wants to invest in a physical property for income purposes is to become a buy-to-let investor. This typically would involve buying a rental apartment, as these have low obsolescence risk, bank funding is relatively easily obtained and the price paid tends to be within reach of an individual investor. However, by forgoing an investment in the listed sector, investors may be missing out on potentially superior opportunities within property sub-asset classes they would not otherwise be able to access on their own, such a convenience retail centres, modern, triple-net leased logistics properties and self-storage units, all of which have performed robustly despite the downturn in the South African property market. If willing to invest offshore, there are even more options available on global listed real estate markets that can represent myriad opportunities and therefore high opportunity costs for the direct property investor.

Investing in direct property also results in lower levels of diversification when compared to a listed property investment. Listed companies tend to be invested across geographies, and own multiple buildings which are let to numerous tenants. Therefore, the potential adverse effects of any one neighbourhood, building or tenant going bad are reduced substantially through the benefit of diversification within a listed investment vehicle. Conversely, a concentrated exposure in a single, directly owned building may involve more risk, but that is not always the case, provided that the risk of obsolescence in the building is adequately considered. An investor should be asking themselves important questions such as: “Should the tenant vacate, will I be able to re-let the building easily?”; “Am I able to tolerate a period of vacancy in between letting”; “Do the amenities around the building support growing or shrinking rents?”

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Investors should avoid "Diworseification", as coined by Peter Lynch: it would be better to buy a single, superior-quality property than a portfolio of poor ones, even if they are conveniently packaged in a listed entity. You will probably be better off buying a rental apartment close to a good university than opting for exposure to a B-grade office block with very high vacancies or risky tenants.

Hidden costs can eat significantly into the returns of direct property investors who have not weighed up all the risks. Physical properties are likely to require periodic and sometimes unexpectedly expensive repairs, risks investors often do not fully account for. Compliance with health and safety protocols, especially air conditioning and fire compliance, in commercial buildings can render older buildings less valuable than the rents suggest, and an apartment block in a sectional titled complex may have a significant unbudgeted or unfunded liability. Equally, seeing to the day-to-day operations of a property may require some of your valuable time, or otherwise there could be costs for you to employ someone to look after the building. An appropriate due diligence before purchasing is essential. Though one avoids this in a listed investment, it does not absolve an investor from "kicking the tires" of the shares they invest in, as similar risks may manifest in listed entities.

The majority of listed property companies in South Africa are Real Estate Investment Trusts (REITs), which enjoy tax-privileged status that unlisted property companies do not. One may need to consider your own tax situation and which is the most efficient ownership structure for you.

Lastly, one must consider the three L's: leverage, liquidity and lawyers, all of which can be costly if not managed correctly. Regarding leverage: banks tend to be less willing to lend against listed property than physical property, as the value of the collateral in the case of physical property is regarded as more stable. Debt can both magnify and significantly diminish returns, so it should be used with care, though property does lend itself to a greater use of debt than many other industries.

Listed property stocks are also more liquid than a physical property, in that physical property transactions

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may take several months to complete, whereas listed property can be bought and sold on the stock market with comparative ease. This liquidity may be a double-edged sword as, unlike a single property which requires only a single buyer, the market price of a listed share is set by hundreds of participants and there is no guarantee that a holding in a listed property entity will reflect its true net asset value. Therefore a forced sale may result in losses if the investor is unable to wait until the company reflects the value of the underlying portfolio.

Physical property transfers also involve lawyers, which add to the transaction costs of buying and selling property and may be a significant cost.

For investors who want to add property assets to their portfolio, the listed property market holds much appeal for its diversification, liquidity and hassle-free investment.. They may well find that the rewards outweigh the pitfalls of the hard work of physical ownership. ■

Yusuf joined Prudential in October 2018 and is the joint-Portfolio Manager of the Prudential Equity and Enhanced SA Property Tracker Funds. He is also responsible for the property allocations within Prudential's multi-asset funds, as well as equities for Namibian clients. Yusuf has seven years' industry experience, and holds a B.BusSc from the University of Cape Town. He is a qualified Chartered Accountant and CFA Charterholder.

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Using forecasts in building portfolios: A perilous undertaking

DAVID KNEE
CHIEF INVESTMENT OFFICER

KEY TAKE-AWAYS

- *History has shown that it is dangerous to rely on forecasts for macro variables or the outcomes of important events to decide how to invest, as even the experts often get their calls wrong and cause large losses for their clients. We have seen innumerable examples of this in recent years.*
- *At Prudential, we do not rely on forecasts. Instead, we assign a valuation to an asset and compare it to its market price. The quantum of difference reflects the risk premium (or discount) assigned by the market. We are mindful of the future scenarios that markets are embedding, and to the extent that these become excessively focused on a single idea*

or outcome, then the potential for a future market surprise is elevated, as is that for sharp shifts in price. We can then position our portfolios to take advantage of such opportunities where valuation is on our side.

For some investors, forecasting the future is an integral part of their investment process. This is because the price of an asset is nothing more than the present value of the cashflows it is expected to generate in the future, and these future cashflows are influenced by myriad macro variables. As a consequence, investors spend an inordinate amount of time considering what that future might hold and imagining complex scenarios of how events are expected to unfold -- from which judgements are made about whether the current asset price offers value.

Humans really know little about the future

Yet at Prudential, we recognise that while we know the past and we are living in the present, there is little we can genuinely say about the events of tomorrow. Time and again markets are surprised by the circumstances presented to them. This suggests to us that it is difficult to base your investment process on one that seeks to forecast what will happen with any accuracy. Our starting point is not to ask: "what will tomorrow bring?" but rather, amid the uncertainty of the future, how much risk premium is embedded in current market prices that could protect a portfolio in the event of adverse outcomes. At Prudential, valuations are the critical input, and history has suggested that owning assets where those risk premiums are high adds risk protection by skewing the likely investment return distribution in your favour. In other words, if a future event or macroeconomic data turns out much worse than expected, the asset already priced with a high risk premium by the market should, in theory, fall less than other assets. Equally, if the event or data turns out better than expected, that asset should gain more than other assets.

Of course, there are no guarantees. Even a great hand can still lose at the blackjack table once in a while; but not every time and not over the long run. Consistently skewing the odds in your favour is key to superior returns. What we can't say is what will happen to interest rates the next time the Federal Reserve meets, or whether Britain will manage to sign a trade deal with Europe, or if South Africa's GDP will be -6% or -10% this year. We do know that these issues will influence markets, as investors integrate the news into prices as it emerges. However, the news flow is entirely unpredictable, and sometimes its effect on markets is unexpected, making forecasting a perilous business.

We also often see examples where changes in asset prices alone become market-moving factors: they can produce a spiral where risk-loving or risk-averse behaviour reacts solely to shifts in prices to drive further increases or declines.

History points to a low probability of getting it right

As such, we do not base our investment decisions on forecasts for any specific events or macro variables. This is a deliberate decision on our part, since time has shown that: 1) the probability of getting such a call correct is low; and 2) even if you do get a call correct, the market reaction isn't consistently predictable. Together, the low probability of getting a macro call right and the low probability of predicting the correct resulting market move present investors with a high-risk decision, one that we believe is too risky to invest clients' money in.

Taking a look at past evidence, in January 1990 the US began its campaign to liberate Kuwait from the Iraqi forces that had invaded it. Between then and June that year, when victory was officially declared, the S&P 500 rose 20%. More recently, in the second half of 2008, when Lehman Brothers failed and the US government was forced to bail out AIG, guarantee money market funds and start quantitative easing, South African government bonds rallied 400 basis points. In the six months before that, as the US sub-prime debt market started to sour, few people, and certainly no one at the Federal Reserve or in government, suggested the worst global recession for 50 years was knocking at the door. Some of those that did call the Global Financial Crisis also lost out – once the market had fallen significantly, they were then stuck on the sidelines, so that as the stock market tripled between 2009 and 2013, they missed out on most of the gains. Even the most respected global analysts have been badly wrong, such as when Goldman Sachs in 2008 famously forecast the oil price to rise from $100 per gallon to as much as $200, only for it to halve over the following months.

At Prudential we didn't know that China was about to embark in 2009 on unprecedented stimulus packages; we didn't know that in 2011 Mario Draghi would say that he would 'do whatever it takes' to save the Eurozone; we didn't know that global interest rates would end pinned at zero. However, we did recognise that by late 2008, equity valuations were extremely compelling: the Price/Book value ratio on the JSE All Share Index fell to 1.0X, an all-time record low, offering great potential return upside since the potential distribution of outcomes was skewed in investors' favour. At the same time, 10-year SA bond yields had reached 7%, close to an all-time low, and offered poor value. In 2009 equities began a multi-year rally which led them to ultimately more than double in value. Bonds had a miserable year, despite the SA Reserve Bank slashing short-term interest rates again and again.

Today we are staring down the barrel of the US Presidential elections on 3 November. In light of the above, it shouldn't be surprising that even though the majority of professional pollsters and experts are predicting a solid Biden victory, we are not explicitly factoring this specific outcome into our portfolio positioning. Just look at the outcome of the 2016 US election when Trump was elected, and the Brexit vote the same year. As is well known, most forecasts predicted a solid victory for Hillary Clinton, and a fall in the stock market if Trump won. But neither came to pass. Equally, Brexit passed when David Cameron had been convinced this could never happen, and as recently as February this year the IMF (with hundreds of the world's most educated and respected economists) had suggested the world economy would post positive GDP growth.

Our valuation versus the market price

In building our Prudential portfolios, we analyse the value of an asset based on its own history and relative to other assets. We also assess the market's pricing of that asset, and carefully consider how this might

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protect us against adverse outcomes. If our calculated value is different than the current market price, then the quantum of difference reflects the risk premium (or discount) assigned by the market. We are mindful of the future scenarios that markets are embedding, and to the extent that these become excessively focused on a single idea or outcome – for example, the US/China trade war that dominated trading during periods in 2019, or the daily Covid-19 infections or death rates earlier this year – then the potential for sharp shifts in prices is increased, and we can position our portfolios to take advantage of such opportunities where valuation is on our side.

It is certainly not the case that "we know nothing" about the future. Nor is it simply saying that we know what valuations should be. It is a combination of attempting to consider what the market is "thinking", how much weight it is putting on single ideas, and how invested the market is in a particular outcome, given that we know particular outcomes rarely unfold as forecast. These conditions represent opportunities for us. This makes us contrarians in the market, and as such we must be very risk-aware in building our portfolios.

Controlling risk

Risk control is therefore a key part of our process: we assess the risks associated with each asset, as well as a combined portfolio's overall risk. The risk analyses we run take into account the portfolio's exposure to macro variables like interest rate risk, currency risk, event risk, etc. We then decide if we have any unintended positions that could make the portfolio too risky or too skewed to a particular outcome. It can happen that the one scenario the market is betting on (and that implicitly we are positioned against by backing lower-valued assets) comes to pass. It can also happen that valuation signals are eroded by unexpected outcomes – for example, the destruction of property company earnings under Covid-19 such that an asset class that looked cheap was in fact expensive because the earnings were about to disappear.

In summary, at Prudential we will not take an explicit bet on the outcome of a future macro event (like the US election) or macro data because we believe that approach is too risky for our clients. Forecasts are very seldom correct, and the chance of loss is therefore too high. However, at the heart of our investment process we consider the current market valuation of an asset, which includes the risks (current and future) the market is attributing to it, and carefully assess how this might protect us against future adverse outcomes. ■

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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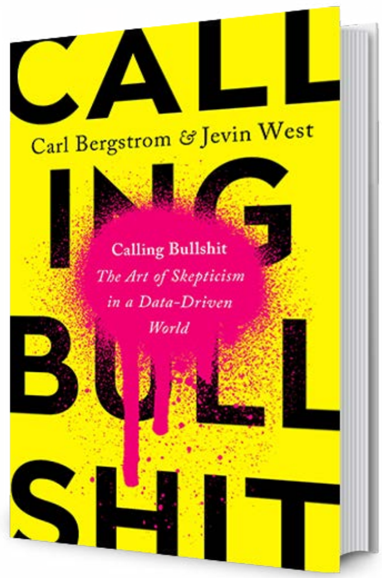
A handbook to 21st Century life

Clare Lindeque
Head of Quantitative Analysis



If 2020 – or the twenty-first century – needed a handbook, this is it. In *"Calling Bullshit: The Art of Skepticism in a Data-Driven World"*, science professors Carl Bergstrom and Jevin West have adapted the syllabus of the popular undergraduate course they've been teaching at the University of Washington since 2017, to provide the rest of us with a fantastically useful guide to recognising bullshit, to figuring out why it is so, and to calling it out. This last step of the process – what the authors call "the performative utterance in which one repudiates something objectionable" – is the reason the book's title has the word "calling" in it, as opposed to just "spotting". As you may have already discerned, a solution to the ongoing epidemic of garbage information requires us to shine a light on bullshit, and, as the authors put it, "demand better from those who promulgate it".

The first section of the book grapples with definitions and ideas: what is bullshit? Where does it come from? Why is there so much of it? The second section gives practical tools for identifying it in the wild; and the final chapters provide broad guidelines for spotting, and then refuting or challenging it.

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If you're looking for a list of news sources that you can believe unquestioningly, or a single arbiter of truth to consult on all matters, this book will disappoint. But if you're looking for tools to read graphs more intelligently, to parse statistical claims, to apply logic to a spurious line of reasoning, to think cogently about artificial intelligence and big data, and to better understand the practice and process of science, Bergstrom and West are here to help.

The scientific method may be "humanity's greatest invention"; it enables us, through an iterative, self-correcting process, to arrive at truths about the world we live in. Scientists primarily communicate their findings through technical papers that are reviewed and accepted by their scientific peers (not in 40-minute YouTube videos or emoji-laden Facebook posts). These papers do not contain the sort of triumphant absolutist language that one might expect from "eureka!" moments. Uncertainty is intrinsic to the scientific process. The aim is the reduction of uncertainty; the absence of uncertainty should be regarded with extreme suspicion. The scientific process may be slow and appear fraught with irresolution, but it works. The smartphone in your pocket, the fact that you still have almost all your teeth, and that your life expectancy at birth was substantially greater than 30 years, are testament to that.

Unfortunately, in the throes of a rapidly unfolding global epidemiological event, it has been easy for bad actors and the misinformed to co-opt the language of science (and hence an air of legitimacy), but not its procedural rigor. Part of the psychic discomfort associated with life in 2020 has been related to the amount that we do not know, and to how rapidly the state of knowledge has been changing and evolving. Most of us – non-scientists – are accustomed to things being "settled", not to having to learn alongside members of the scientific community, or to actually see the scientific method in action.

It is human nature to seek out certainty, and those peddling it, but we may rather have to follow the advice of Rainer Maria Rilke and "live the questions", until we eventually "live along some distant day into the answer". We already know substantially more about life with the novel Coronavirus than we did in January of this year, but

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filtering out the bullshit to arrive at these truths has been an often exhausting and frustrating challenge. "Calling Bullshit" was published in August, but we've needed it for far longer than that!

I found this book to be practical and empowering. It will be useful to you long after Covid-19 has been squashed. It'll assist in every aspect of your life, from navigating the sometimes confusing world of investments, to dealing patiently, kindly and factually with your tinfoil-hat wearing mother in law. Some countries, like Finland, are working to equip their school-age young people with the sort of tools that this book provides. Most of us did not grow up in a world (or country) that recognises the threats to democracy, human health and safety presented by the firehose of bullshit we're exposed to daily, from ever-increasing numbers of sources. Bergstrom and West offer an opportunity to remedy this deficit. If you're going to act on one Consider This book recommendation, please let it be this one. ■

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. Clare 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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