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Letter from the CEO

Benard Fick
CHIEF EXECUTIVE

Dear Prudential client,

In the last quarter of 2020 we saw that, even as a second wave of Covid-19 infections spread alarmingly, causing tighter lockdowns and many more deaths, global financial markets celebrated the rollout of vaccines in many of the larger economies by broadly pushing equity markets to record highs -- a stark dichotomy of sentiment. The worsening of health and socio-economic conditions on the ground was largely ignored as investors began to look ahead to better growth prospects in 2021 and beyond.

At Prudential we did not ignore the real-world impact of the pandemic, instead urging our staff and their families to take even more precautions and avoid becoming complacent, especially during the holidays. We hope this was the case for our clients as well, and that you all managed to

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enjoy a safe, healthy and happy year end.

Investment returns surprisingly positive for 2020

It proved to be a surprisingly good year for many investors based solely on the total returns recorded by many different asset classes around the world. This was due largely to November's vaccine-related developments, as well as the election of Democrat Joe Biden as US President. Other factors contributing to the strong risk-on sentiment were the US Congress' agreement of a fourth large stimulus package in December, and the UK and EU's last-minute conclusion of a Brexit deal.

We also saw some early evidence of investors beginning to realise the extraordinary value on offer in certain sectors of the South African equity market that were particularly beaten down in the March 2020 market correction. We experienced a strong rebound in the financial sector, and SA banks in particular, where our client portfolios held fairly significant positions. More broadly, the improved global sentiment helped both the local bourse and SA bonds to deliver positive returns for the year, and at levels that would not have been expected as recently as October. The FTSE/JSE All Share Index (ALSI) managed to record a 7.0% total return in rand terms over the 12 months, and the All Bond Index (ALBI) produced 8.7%.

The rand also staged a reasonable recovery in the latter months of 2020 from oversold levels, but still ended the year weaker, losing 4.6% against the US dollar, 9.0% versus the pound sterling and 14.4% against the euro. As such, local investors would have benefitted from their offshore returns being boosted by rand depreciation.

The table below shows the decent gains in 2020 across major asset classes, with the notable exceptions being global and local listed property stocks. Even global bonds delivered an unexpectedly robust 9.2% total return in US dollars, considering the high prices at which they started the year, as central banks and investors continued to buy up supply.

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ASSET CLASS	TOTAL RETURN Q4 2020	TOTAL RETURN 2020
SA equity – FTSE/JSE All Share Index (in rand)	9.8%	7.0%
SA equity – FTSE/JSE Capped SWIX All Share (in rand)	11.5%	0.6%
SA listed property – FTSE/JSE SAPY (in rand)	23.6%	-37.5%
SA bonds – BEASSA All Bond Index (in rand)	6.7%	8.7%
SA inflation-linked bonds – JSE CILI Index (in rand)	5.4%	4.2%
SA cash - STeFI Composite Index (in rand)	11.0%	5.4%
Global equity – MSCI All Country World (Total) (in US$ net)	14.7%	16.3%
Global equity – MSCI World (Developed) (in US$ net)	14.0%	15.9%
Global equity – MSCI Emerging Markets (in US$ net)	19.7%	18.3%
Global bonds – Bloomberg Barclays Global Aggregate Bond Index (in US$)	3.3%	9.2%
Global property – FTSE EPRA/NAREIT Global Property REIT Index (in US$ net)	13.6%	-11.4%

Prudential fund performance

The past 18-month period was one of the most challenging in Prudential's more than 25-year history. We share our clients' disappointment in our portfolio performance over the period (which have also weighed on the medium-term performance, as reflected in the table). After all, Prudential staff's own retirement savings are invested alongside our clients in these funds.

Our investment teams spent considerable time and effort in 2020 to review all portfolio positions and the investment case for each, in significant detail. We further used the market correction to rotate some positions in order to exploit the opportunity to build positions in a handful of specific high-quality companies, at generational levels of cheap valuations.

It is therefore pleasing to observe the strong recoveries posted by nearly all our funds over the last three to four months of the year, as highlighted in the fourth quarter returns in the table, which shows the annualised returns of

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PRUDENTIAL FUND PERFORMANCE to 31 DECEMBER 2020

Prudential Unit Trust Fund	Q4 2020 RETURN %	1-YEAR RETURN %	3-YEAR RETURN P.A.%	5-YEAR RETURN P.A.%	10-YEAR RETURN P.A.%
Equity Fund	12.6	9.2	2.3	5.4	9.7
Benchmark	9.6	1.9	0.5	3.1	6.9
Dividend Maximiser Fund	10.0	4.0	1.8	4.2	9.0
Benchmark	9.6	1.9	0.5	3.1	6.9
SA Equity Fund*	12.0	-4.2	-3.1	3.0*	8.8*
Benchmark	11.5	0.6	-1.5	3.1	7.9
Enhanced SA Property Tracker Fund	21.4	-35.6	-21.6	-9.5	3.0
Benchmark	22.2	-34.5	-20.7	-8.4	3.5
Balanced Fund	7.0	2.3	2.5	4.6	9.2
Benchmark	5.9	5.2	3.6	4.4	7.7
Inflation Plus Fund	5.3	-0.7	0.1	2.8	7.9
Benchmark	1.6	8.2	9.0	9.6	10.1
Enhanced Income Fund	2.8	4.2	5.5	6.9	7.3
Benchmark	1.0	5.4	6.6	7.0	6.9
Income Fund	1.2	5.1	7.5	N/A	N/A
Benchmark	1.0	5.4	6.6	6.9	N/A
Global Equity Feeder Fund	1.5	15.9	11.7	8.1	15.2
Benchmark	0.6	21.6	16.6	11.0	18.1
Global Balanced Feeder Fund	-1.1	10.5	N/A	N/A	N/A
Benchmark	-2.7	18.3	N/A	N/A	N/A
Global Inflation Plus Feeder Fund	-4.0	11.4	9.9	4.1	11.0
Benchmark	-12.4	5.2	5.0	0.5	9.3
Global Bond Feeder Fund	-7.3	14.2	10.4	3.5	11.6
Benchmark	-9.4	14.2	11.1	3/6	11.3

SOURCE: Morningstar

*SA Equity Fund 5- and 10-year returns reflect zero-fee B Class returns.

All other funds are A class returns (returns after all fund management fees and other charges).

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our Prudential Unit Trust funds for different periods up to 10 years. While fund performances have not fully returned to their long-term benchmark-beating levels, we are confident that portfolios are positioned appropriately under the circumstances, and we anticipate much more pleasing outcomes over the next three to five years.

What has 2020 taught us?

Amid a global pandemic that has lasted for a year, and widespread lockdowns that have caused the South African economy to shrink by an estimated 8.0% for the year, who would have predicted that the SA equity market would still manage to deliver a 7% return for the year? Against most expectations, hindsight showed us that investors who maintained their equity exposure for the duration of the year, probably came out in better financial health than would have been expected.

Just as surprisingly, South African bonds were able to deliver an impressive 8.7% return for investors in 2020. This, in a year during which the government's credit rating was downgraded further into junk status and the budget suffered severe revenue shortfalls and funding challenges. Given the extra bond supply required, investors could have reasonably expected a weaker local bond market for the year, but in the last three months,

both local and global investors snapped up SA government bonds due to their attractive yields in relation to global alternatives. This resulted in unexpectedly good gains for bondholders in a year of very bad news for the bond market, and supported our previous viewpoint that investors had materially priced-in a ratings downgrade well before it actually occurred.

So 2020 has (once again) reminded us that anyone's ability to make money from forecasting is limited at best, and that it makes sense to stay true to your investment strategy even in the midst of extreme short-term uncertainty and volatility. Investors who panicked amid the March 2020 correction, and sold out of growth assets such as equities to park their

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funds in "safe" money market funds, only managed to lock-in their capital losses and would probably not have experienced the subsequent recovery as equity markets recovered.

For Prudential's part, we promise to remain patient, keep a long-term outlook and follow our consistent investment process to deliver competitive, inflation-beating returns for all our clients. We are hopeful that asset prices will continue to recover in the months ahead, as the global vaccine rollouts progress and start to contain the pandemic, gradually improving the physical, mental and financial health of everyone. In South Africa, however, there is additional work to do since the economy and government's fiscal position present some very significant challenges that will take a concerted effort from all sides to resolve. At Prudential we are committed to playing our part in this effort.

We hope you enjoy this Q1 2021 edition of Consider this, and as always welcome any feedback you may have.

Sincerely,

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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KEY TAKE-AWAYS

- *While multi-asset low-equity unit trusts like the Prudential Inflation Plus Fund have underperformed in the last three to five years, most have rebounded since the lows of late March 2020.*
- *Although there has been a wide divergence in returns within the category, the Inflation Plus Fund has returned over 30% during the period, and we are excited by the Fund's prospective returns of 6-9% p.a. above inflation over the next five years.*
- *This high prospective return range relative to its history (its objective is 4% above inflation) is due to the very attractive prevailing asset valuations across a range of asset classes the fund is holding, which increase the chances for it to outperform as well as giving it enhanced downside protection.*
- *Based on this, investors should consider remaining in the Inflation Plus Fund in order to catch up on the underperformance of previous years.*

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I have invested some of my retirement money in a multi-asset low-equity fund, but it has been underperforming its benchmark for over three years. I see returns have started to pick up now - should I sell my holdings and move somewhere else?

A Over the past five years, investors have certainly been disappointed with the low returns delivered by funds in the ASISA Multi-Asset Low-Equity category of unit trusts, which have underperformed their historic averages as well as lower-risk fixed income and cash investments. However, over the relatively short period since the worst of the Coronavirus-related market crash in late-March 2020, South African asset prices have recovered significantly across a range of asset classes, with fund performance reflecting this. In the Low-Equity category, the average fund has returned a very respectable 21.3% from its lows, but there has been a wide divergence of returns between the funds, with the lowest delivering only 1.8% and the highest producing 36.3%. Consequently, the investor experience has likely varied from extreme disappointment to relative satisfaction.

Prudential's Inflation Plus Fund has been one of the very top-performing unit trusts in the category with a 33.1% return over this period, repeating its historic tendency to outperform in periods when higher-risk assets perform better than lower-risk assets. We know there is still much ground to be recovered by investors, but we are excited by the fund's return potential over the next five years. Investors should be as well. This is thanks to a unique set of opportunities that presented itself in 2020 in the wake of the Coronavirus crisis. While we certainly owned a lot of assets – both equities and bonds – that fell sharply, we were able to sell some that didn't fall as much, rotating into others that presented much better upside potential. This has left the Inflation Plus Fund with excellent prospective returns and downside protection, thanks to both the very low valuations (some at generational lows) at which we have been able to buy selected assets, and the fact that

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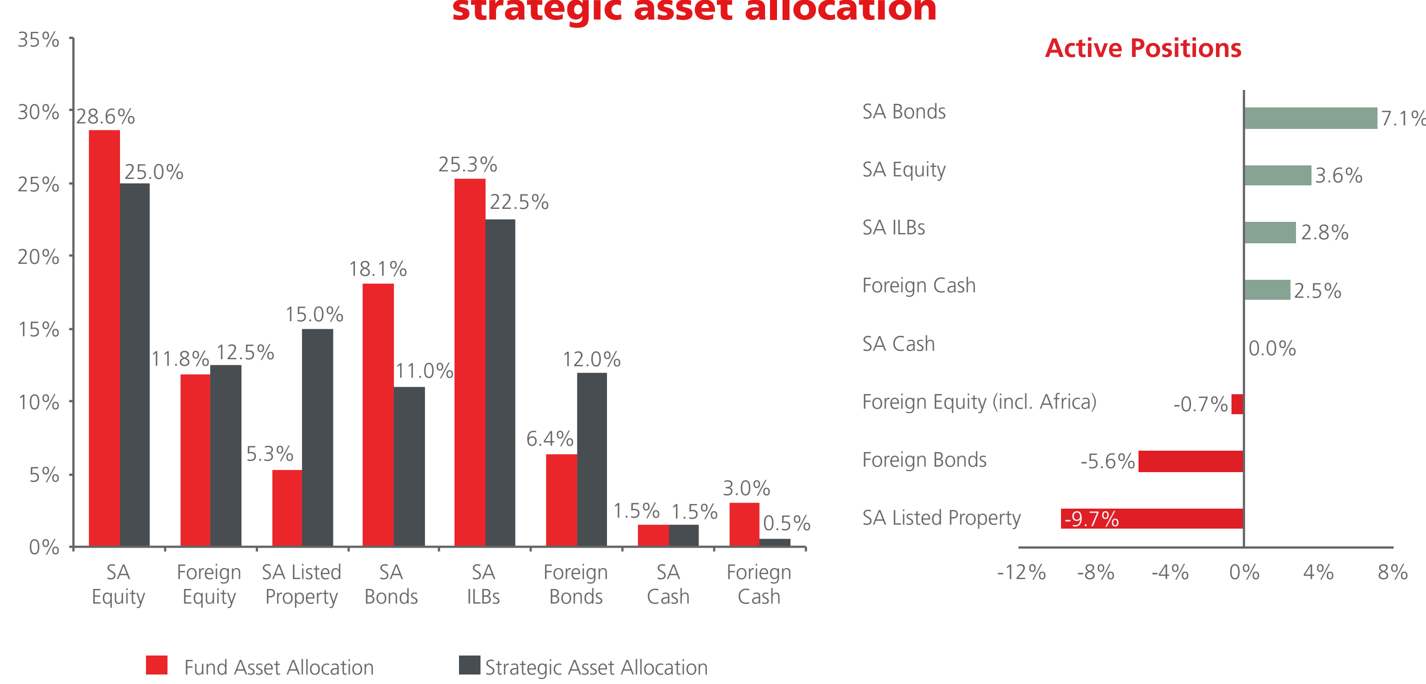
such a large and diverse proportion of assets have such high prospective returns compared to their history. Both of these factors increase the probability of fund outperformance into the future under various scenarios. The downside protection is enhanced even more by the fund's carefully considered diversification and Prudential's risk-conscious portfolio construction process.

We prefer SA bonds, SA equities and SA ILBs

Looking at the fund's positioning as of the end of 2020, as shown in Graph 1, it holds large active overweights to SA bonds and SA equities, and a moderate overweight to SA inflation-linked bonds (ILBs). According to Prudential's valuation analysis, although all these assets have become less cheap in recent months, they are still valued at levels well below their historic fair value. For SA bonds, the prospective five-year real returns are the highest they have been since 2004, with the 20-year government bond indicating a real return of 7.6% p.a. and the 10-year bond 5.9% p.a. as of the end of 2020.

GRAPH 1: Inflation Plus Fund: Active positions vs strategic asset allocation



SOURCE: Prudential Investment Managers

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ILBs are also an attractive holding in the portfolio for their excellent diversification and inflation protection qualities. Investors worried about a potential government default would do well to hold these as protection against such a scenario, rather than opting for cash. Our analysis shows ILBs should deliver a real return of around 4.1% p.a. as an asset class compared to their historic average of 2.0% p.a. real. Prudential's valuations for prospective real returns for each asset class are shown in Graph 2.

As for SA equities, their valuations at the end of 2020 pointed to a real return of 9.5% p.a. for the asset class over the next five years, versus their historic fair value of 6.5% p.a.. While SA listed property is at first glance trading even more cheaply at a prospective real return of 9.5% p.a. compared to its historic fair value of 6.0%. p.a., we are concerned about the high earnings uncertainty in the sector combined with relatively high levels of debt and weak growth prospects. We therefore have a significant underweight to listed property in the Inflation Plus Fund. There is a higher degree of safety in other equity sectors with equally high return potential, such that we prefer taking overweight positions in sectors such as banks (Standard Bank and Absa are among the fund's top overweights). The fund has its other significant overweight holdings in large, diversified global companies like British American Tobacco and Anglo American, and in well-valued groups like Multichoice, all with good potential to outperform the market.

Underweight global bonds

Examining offshore positioning, Inflation Plus has a large underweight to global government bonds due to the negative yields prevailing broadly across developed markets. Although historically global bonds have offered an average real return of around 1.8% p.a., currently as an asset class they are set to deliver -0.6% p.a. as Graph 2 highlights. The fund also has a small underweight holding in global equities, since global markets are collectively slightly expensive due to the predominance of the expensive US market. As an asset class our valuations show the five-year prospective real return from global equities at 4.9% p.a., when historically their fair value has been 5.5%. On top of this, the rand remains undervalued against the major global currencies, so that

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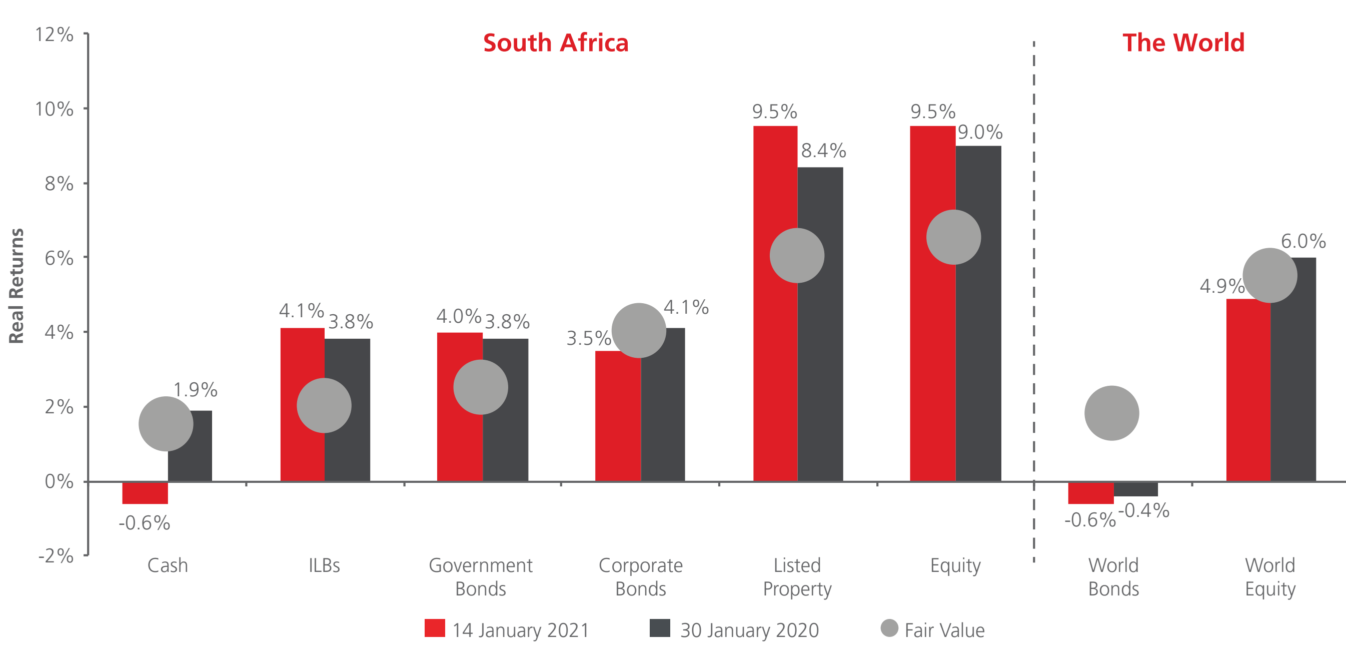
any appreciation from current levels could contribute to losses in rand terms going forward.

Prospective real fund returns of over 6.0% p.a.

Looking at the fund's overall asset holdings and their current valuations, the Inflation Plus Fund is set to deliver a real return of over 6.0% p.a. over the next five years. This assumes that nothing else changes and asset prices and market ratings stay the same going forward. However, should asset prices rise to reach their long-term "equilibrium" or fair value levels, the fund has a prospective real return of 9.0% p.a. It is positioned to outperform its history under a wide number of conditions, including: if the status-quo continues; if SA equities re-rate; if the SA yield curve flattens from its current steep shape; or if the listed property market rallies. It is likely to underperform, however, if the SA yield curve steepens further; if there is a repeat of the listed property crash we experienced in 2020; or if South African and global equity markets de-rate going forward.

As the first two scenarios are highly unlikely, we have a higher degree of confidence in the upside for future

GRAPH 2: Prospective real returns



SOURCE: Bloomberg, Reuters, Prudential Investment Managers 14.01.2021

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fund returns than the downside. With South Africa's short-dated interest rates at such low levels already and longer-dated bond yields high compared to their history, further significant yield curve steepening is not likely. And based on the exceptionally low valuations for listed property currently, we wouldn't expect these assets to de-rate by the same extent in 2021.

A return of 6.0% above inflation is one that has typically been delivered by high-risk, equity-only funds in the South African investment industry. So a similar level, or the potential for a 9.0% return, from a lower-risk, well-diversified fund compliant with retirement regulations like the Inflation Plus Fund presents a rare opportunity for investors.

Going forward, investors now have the chance to "catch up" on the inflation-beating returns the ASISA Multi-Asset Low Equity category funds have struggled to produce over the past five years or so. These higher returns are unlikely to come from cash as they did during this period: interest rates are so low that, on our valuation basis, prospective real returns from cash investments are negative over the next five years. So now is not the time to hide in low-risk investments, but instead to hold a portfolio of carefully diversified assets that will provide the potential for excellent, inflation-beating returns with only moderate risk. ■

Sandile joined Prudential in 2013 as a member of the fixed-income team, and later joined the multi-asset team in 2018. He is currently the joint-Portfolio Manager of the Prudential Money Market, Income, High Interest, Balanced and Inflation Plus Funds. His role involves providing analytical and economic support to our multi-asset and fixed-interest investment process. He is also a member of the Prudential Asset Allocation Committee. With 13 years' industry experience, Sandile previously worked for Investec Asset Management as a fixed interest dealer and analyst. He also served as Portfolio Manager on large institutional fixed interest client mandates with liability immunization objectives. Sandile holds a BSc in Mathematical Statistics and Actuarial Science and is a Student member of the Faculty of Actuaries.

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COVID-19 and SA banks: Recovering from the lows

Stefan Swanepoel
EQUITY ANALYST

KEY TAKE-AWAYS

- *SA banks were as well-placed as possible to cope with stress arising from the impact of the Coronavirus, with all-time high provisioning and tight lending criteria already in place.*
- *Lower retail transactional income was offset to some extent by higher revenue from facilitating client risk hedging.*
- *Although loan impairments have risen, client support in the form of repayment deferrals, government financial support and interest rate cuts helped mitigate the deterioration in banks' loan books. Banks have not been as hard-hit by the crisis as could have been expected.*

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South African banks have certainly not been immune to the impacts of COVID-19. The first half of the year was characterised by uncertainty, with markets expecting banks to post significant losses and potentially needing to raise capital. The second half of the year saw these fears moderating. The banks have proven to be resilient, with the conservative standards of the Basel capital accords and our own National Credit Act allowing the banks enough headroom to deal with the negative impact.

While the devastation of the pandemic continues and the chances of further severe lockdowns cannot be overruled, the banks have built up some of the largest provisioning buffers on record (see Graph 1) thanks to the forward-looking accounting principles embedded in IFRS 9. Lower interest rates, while hurting banks' net interest margins, have boosted the ability of borrowers that were not impacted by job losses or COVID-19 disruptions to repay. They have also improved affordability, and we have seen an uptick in retail asset growth demand. The banks' operations in the rest of Africa (excluding South Africa) have proven to be more resilient than the domestic franchises. In our view, all is not lost, the businesses remain resilient and we expect to see a continued recovery in earnings off the depressed bases.

Digital adoption accelerates

Earlier in the year, as concerns over how rapidly the virus was spreading set in, many banking customers were forced out of branches and onto digital channels. While this transition was already in progress, its pace was dependent on the willingness and digital enablement of clients. Particularly marked accelerations were noted in Europe among the older population, where digital adoption was historically slow. While this will not result in overnight cost savings for the banks, the higher level of online engagement does improve their ability to cross-sell products. It is also linked to lower costs; however, the banks still sit with physical branch infrastructure that needs to be serviced. As the branch leases are renewed, the banks can reduce their cost bases either with complete closures of certain branches or a reduction in floor space. These benefits will filter in over the next few years.

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One may be forgiven for thinking that this gives new (digitally advanced) entrants like Tyme or Discovery Bank a substantial advantage, but that would discount the huge strides already made by the big incumbents. Most of the existing banks' online branches are already by far their largest contributors of new business. With the cost of the existing physical infrastructure already in the base, there is substantial opportunity for savings for them into the future.

Trading volumes remained robust

While transactional revenues on the retail side were depressed during the early period of the lockdown, these have started to show signs of recovery. Large-ticket items relating to travel have been notably absent and may take longer to recover, but the banks have recorded consistent growth since the trough in April 2020. All was not lost as banks also made more money in parts of their trading businesses amid the heightened uncertainty. As investors and corporates hedged out risk, banks as market-makers capitalised on the underlying activity. This boosted earnings into the mid-year June 2020 results reporting, and will contribute to the full year as well.

Into 2021 we would anticipate rising retail transactional revenues to more than compensate for slowing trading volumes as hedging drops from peak levels.

Impairments will take time to work through

As lockdowns were introduced and countries around the world were bracing for the impact, not only on lives but also on their economies, the banks were forced to deal with the uncertain consequences of a new accounting standard - IFRS 9. While forward-looking models are always best for addressing uncertainty, they can have their drawbacks in a global downturn where very few sectors are left untouched. Given the economic woes in South Africa pre-COVID, the South African banks were bracing for rating agency downgrades and potential domestic stress. As a result, their credit-granting criteria was already quite tight heading into the crisis. Provisions-to-advances ratios were at some of the highest levels on record prior to COVID. Banks were as well-placed as possible for any impending stress. Over the interim reporting period mid-year, the banks continued to increase all-time high provisioning

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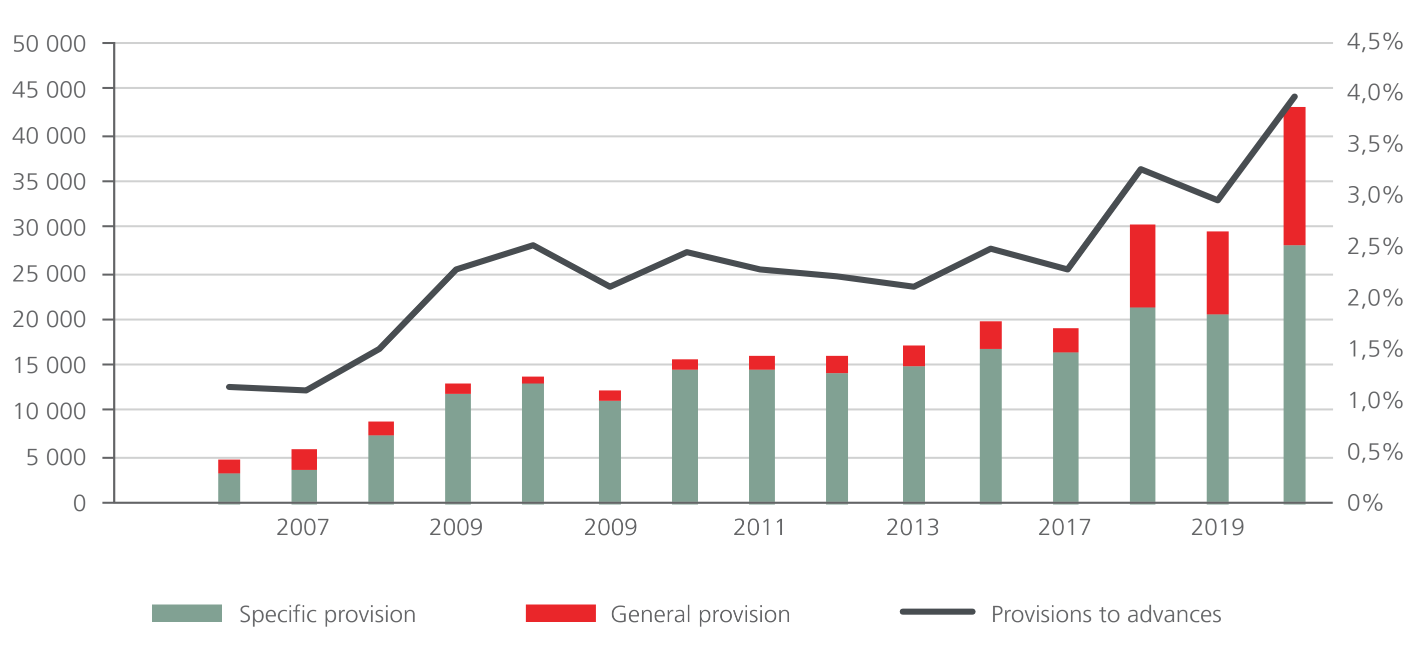
and tighten their lending criteria even further, but the approximate 300bps (3.0%) reduction in interest rates has improved affordability.

Retail clients working in impacted sectors were aided initially by blanket deferrals on their loan repayments or, in the case of FirstRand, by a personal loan. The assistance was subsequently moderated as industries reopened and the lockdown eased. Most banks now require at least partial payments of instalments. While some clients are still receiving payments in the form of government support, as this support is wound down, non-performing loan (NPL) levels may increase. Pleasingly, as the economy reopens, the percentage of assistance provided by banks continues to reduce dramatically from the highs of April 2020. While some clients are still being supported and some risk remains, many loans are protected by underlying collateral such as vehicles or homes. The banks continue to operate in a pragmatic manner and will offer support where needed in future lockdowns.

Graph 1: Absa's provisions at all time highs



SOURCE: Company data, Prudential Investment Managers

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The number of corporates in distress has also decreased; banks continue to track high-risk sectors such as aviation, hospitality & tourism-related industries, commercial property finance and construction. Some companies in these troubled sectors have recently had rights issues, passing the risk onto shareholders and in turn reducing their bank debt exposures. We anticipate more of this to come in due course.

Going forward, the banks will continue to increase their collection capacity in order to support the orderly repayment or work-out of loans. Thankfully the banks have realised that it is in no one's interest to merely evict non-paying customers from their homes and repossess their cars. They have learned many lessons from the 2008 Global Financial Crisis, including trying to assist consumers as best possible with selling their various assets, rather than out right repossession. Similarly, on the corporate side they can earn fees from their clients' capital raises or planned work-outs.

Consumer affordability aided by interest rate cuts

The SA Reserve Bank's interest rate cuts totaling some 300bps have boosted consumer affordability. Given the restrictions imposed by the National Credit Act, these lower interest rates have helped consumers to qualify for higher loan amounts, previously out of reach. Despite banks being cautious about lending too aggressively in this environment and raising their credit granting criteria, the substantial reduction in the repo rate has allowed banks to lower their lending rates but still see an increase in lending volumes. The high activity levels will unlock liquidity from the housing market and continue to boost top-line revenue for the banks. Historically, some of the banks' most profitable business was typically written during the worst economic periods, as banks remain acutely focused on credit risk and margins, and this should hold true going forward as well. The benefit of the lower interest rates has also aided those who have not been financially impacted by the pandemic. The banks have seen consistently better payment trends in the non-impacted sectors.

Africa regions performing better than South Africa

In the rest of Africa, the impact of the pandemic on economic growth and banking sectors in various countries

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has been more muted. Many of the banks posted either limited declines -- or in several instances even profit growth – in their African operations during the period, with low levels of penetration and more resilient economies supporting the bottom line. While the Africa regions are not immune to impairment risk, transactional activities and deposit-ed franchises still make up the bulk of the underlying businesses; earnings from lending activities are less important. However, it is notable that the best-performing franchises still have as diversified a portfolio as possible.

In our fund positioning we favour those banks with strong franchises built up in the rest of Africa. These are extremely hard to replicate given the unique operating environment and political risks embedded in the various geographies. With the growth outlook in the rest of Africa better than the domestic outlook, we think this will prove supportive for continued earnings diversification and higher profitability for banks. We have seen the rest of Africa make up an increasingly greater share of group profitability, and the region could make up the bulk of bank profits in due course. Both Absa and Standard Bank continue to have standout franchises in the rest of Africa.

Capital remains robust as regulators consider a return to dividends

In what is a positive development globally, regulators are retracting the blanket bans for banks on the return of capital (or dividend payments) imposed at the start of the pandemic. While initially concerned about the uncertain impact from COVID, most of the banks have proven to be much more resilient post the Global Financial Crisis. In our view, the signal this is sending is more important than the actual payment of a dividend; regulators would not allow banks to return capital to shareholders if there were material concerns over future losses. If a bank rather elects to retain its capital, it still aides in increasing the book value of the bank, and the capital could be returned at a future date.

In Graph 2, we can see how Standard Bank's total capital adequacy ratio (CAR) and its Tier 1 capital ratio have fallen only slightly from the beginning of 2019 through June 2020, remaining at robust levels on par with, or higher

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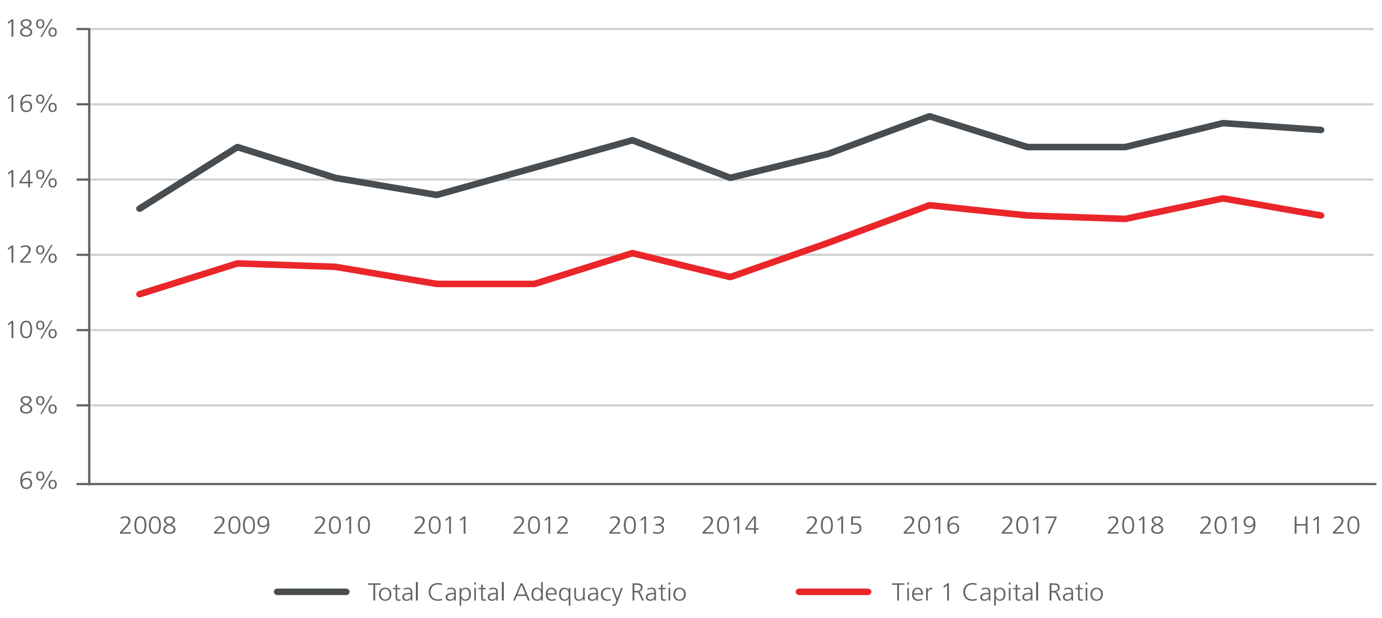
Graph 2: Standard Bank's robust capital level could support a dividend



SOURCE: Company data, Prudential Investment Managers

than, those it maintained in 2018. As the potential impairment risks abate, this would suggest that from a financial health perspective, it could afford to pay a dividend without endangering its financial strength.

Based on the extent to which the banks are trading at discounts to their book values, we think that dividend buybacks would be a preferred way to return capital in due course. The South African regulators have not removed the guidance note issued earlier this year discouraging the payment of dividends; however, they have reminded the market that it is just a guidance note, and the decision ultimately sits with each company's board. In our view, these trends all point to the fact that the worst has passed and the risk of any potential capital raises has been vastly reduced.

A strong indicator of this was the recent upgrade of South Africa's largest five banks' National Long-Term credit ratings to 'AA+' from 'AA' by Fitch, which it said reflected an improvement in their creditworthiness relative to

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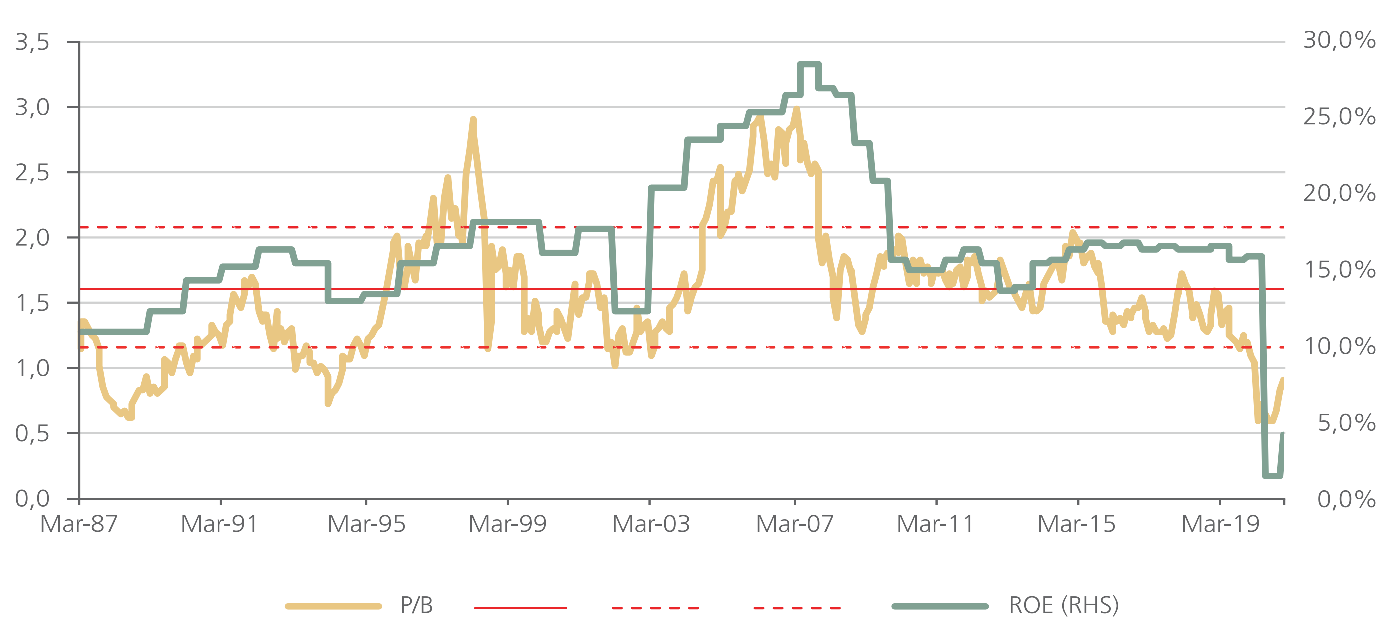
the best credits in the country.

Banks still offer value

Throughout the Coronavirus crisis, South African banks have remained well capitalised, and all signs in the final weeks of the year have indicated that impairments have peaked. Importantly, bank profitability has been robust enough to absorb the high levels of provisioning. None of the big banks posted losses over the period, and net asset value has been preserved. While we are not entirely out of the woods, the risk of a further deterioration in banks' financial health is now lower and signs are pointing towards a better credit experience than what is being provided for presently. This contrasts to equity valuations; for example, Absa trades at a discount to its book value as the market is expecting high levels of losses to continue for the foreseeable future.

Graph 3 shows how Absa has been trading at a price-to-book-value ratio of less than 1.0 since the market sell-off in March, and has yet to recover much ground. We would anticipate

Graph 3: Absa's P/B vs ROE



SOURCE: IRESS, Company data, Prudential Investment Managers

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that as banks' cost of credit reduces, the return on equity (ROE) would recover in due course to pre-COVID levels. We therefore do not believe it is justified that Absa trades at a discount to its book value. As a result, we think the total returns are attractive, as substantial levels of earnings growth over the next few years (in excess of 40%) could be further boosted by improvements in the ratings.

We think this presents an opportunity. While financial activity levels continue to grow off a depressed base and there are opportunities for future cost savings, banks' ROE may take some time to recover, but should trend to above their cost of equity. We think the banks are cheap compared to their longer-term valuations, and we expect them to deliver returns above the broader equity market and greater than their own historic average over time. As such, we are overweight the sector and more specifically, shares like Absa, Standard Bank and Investec, in our best investment view portfolios and many of our unit trusts that hold equity. Our preference for these banks over the other banks is informed by the relative value of the shares. While we rate FirstRand more highly in terms of quality, it is substantially more expensive than other banks in the sector. ■

With 15 years' experience in financial services, Stefan joined Prudential in 2019 as an Equity Analyst focusing on Banking as well as select Property, Speciality Finance and Insurance companies. Stefan was one of the top three rated analysts covering Banks and Specialist Financial Services companies on the sell-side. Prior to that Stefan was on the buy-side focusing on Financial Services companies. He completed his articles at PwC in the FS Banking division and is a qualified Chartered Accountant. His qualifications include B.Com Accounting (cum laude) and B.Com Accounting Hons.

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2020: The year the world remained complex

iStock-933417870

Aadil Omar
PORTFOLIO MANAGER AND HEAD OF EQUITY RESEARCH

- *Despite the seriousness of the global pandemic, global equities (as proxied by the US S&P 500 Index) seemingly shrugged this threat off by trading below their 12-month levels for only 43 days.*
- *Many people thought this comprised irrational behaviour, but it actually reflected the complexity of global equity markets and the vast number of influences and actors that comprise them.*
- *The more accepting we are of market complexity, the better able we are to identify and optimise for those elements that are in our influence.*

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Do you remember your holiday season at the end of 2019? To many readers it will likely be recalled as a less troubling time. You probably walked into the festive cheer reminiscing about the monumental shifts that occurred during the past two decades since the humdrum of the Y2K bug, but nevertheless looking forward to the third. Promising possibilities lay ahead.

Now imagine you knew all the mayhem that would descend over the world in this, the 20th year since the turn of the millennium. Imagine you knew that a respiratory virus would cast a long shadow over the world, rising – as the sun does – in the east before sweeping westward over the globe. And then it made itself at home the world over. In addition to the healthcare crisis, imagine you had the insightful knowledge that the year 2020 would also be host to one of the deepest global economic recessions in living memory plunging millions of people into unemployment and reducing once-towering companies to pale shadows of their former selves. Given all the pain and suffering, distress and financial hardship, loneliness and emotional tumult, brought on by this microscopic virus, you would be forgiven for feeling somewhat less optimistic about the future. A touch of pessimism would not have been without cause.

If this narrative made you somewhat uneasy, I sympathise – writing it was equally unsettling. Despite the uneasiness, there is something surreal about the drama that is Covid-19 and its off-shoots. It is one of the few narratives universally understood and relatable to just about everybody reading this. Covid-19 is probably the first disease (in living memory) the world has suffered collectively in time. It is also likely the first time the phrase “we’re all in this together” has proved true on some level. Equally, Covid-19 was also the first time our species confronted a complex problem in real time.

Financial markets shrugged off the threat

The US bull market before Covid-19 was often scoffed at – I recall a commentator referring to it as “the most hated bull market of all time”.

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Many investors sounded alarm bells as they watched the market continue to rise into the news of Covid-19 all the way to the end of February 2020. Although the sell-off was probably accompanied by a fair amount of panic, when it finally cracked many investors sighed a breath of relief - the markets were finally behaving in a way that was sensible and congruent to the way we were feeling, as locked down citizens of the world. Market rationality prevailed.

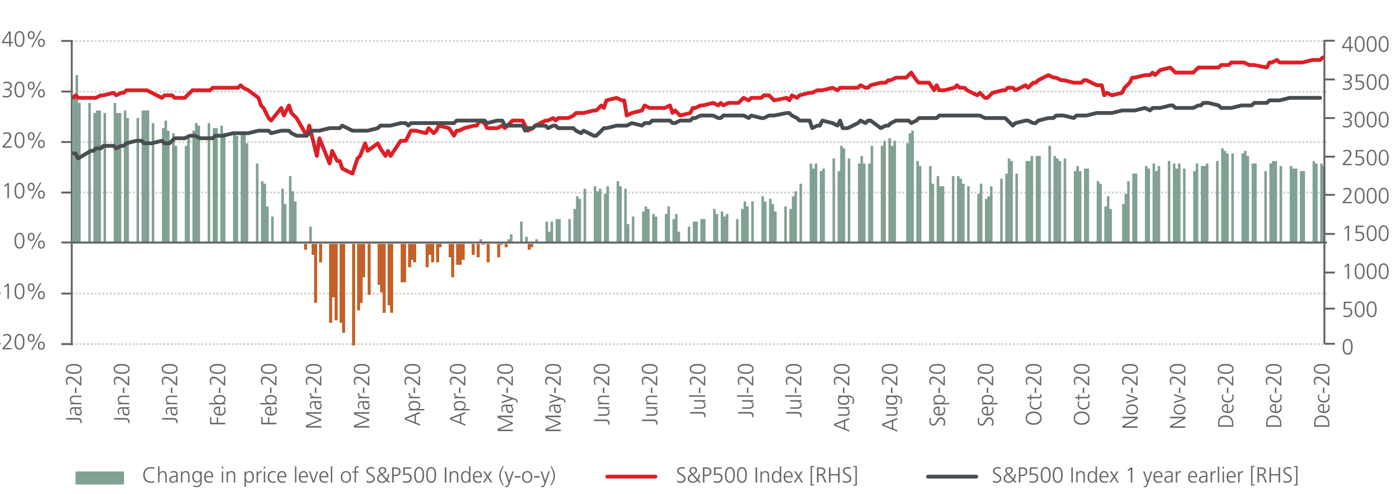
For the S&P 500, the correction lasted all of 43 trading days (see Graph 1 below). Perhaps the price action was rational, but the cries of many market pundits shouting in disbelief at the market's irrationality still grows louder.

Graph 1 tracks the daily change in price of the S&P 500 relative to its price level a year ago. Over the calendar year 2020, the Index traded below its level from a year ago for only **43 days (or 16% of the time)**. This in a year when most people would probably agree with the narrative that the world is somewhat different and perhaps a little scary.

When something is widely relatable it seems only obvious

When a phenomenon is as widely relatable as our experience of Covid-19

Graph 1: S&P 500 price change y-o-y



SOURCE: IRESS Data

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has been it has the potential of framing our world view completely. We then expect all other phenomena we encounter to comply with this view, to live within this frame. The idea that financial markets shrug off the plainly obvious, albeit negative, reality we observe seems preposterous. It is not in the frame. We can only but conclude that the market and some market participants must be irrational and behaving in a way that is counter to reality. This may well be so. But consider the alternative: these comments might hint more at an underappreciation of the complexity of market mechanisms than they say about the rationality of the market.

When we observe real-world phenomena and attempt to translate them into market prices in a direct real-time (or linear) fashion, we fail to appreciate the emergent properties of a complex system. Or as the erudite mathematician and father of fractal geometry, Benoit Mandelbrot, explains, we should recognise there are indeed endogenous features within the market:

"Prices are not driven solely by real-world events, news, and people. When investors, speculators, industrialists, and bankers come together in a real marketplace, a special, new kind of dynamic emerges—greater than, and different from, the sum of the parts. To use the economists' terms: In substantial part, prices are determined by endogenous effects peculiar to the inner workings of the markets themselves, rather than solely by the exogenous action of outside events."[1]

The market exists at the intersection of a vast number of participants, each with their own evaluations, motivations and specific needs. The emergent complexity makes for routine surprises and inexplicable gyrations. While many times a credibly sounding and easily understood rationale is identified after the fact (ex-post), our ability to precisely identify causes and effects ahead of the moment (ex-ante) remains elusive.

Complex means non-compliant to expectation

Brenda Zimmerman of York University and Sholom Glouberman of the

[1]Mandelbrot, Benoit B.The (Mis)Behaviour of Markets (p. 21). Profile. Kindle Edition.

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University of Toronto, professors who study the science of complexity, have proposed a distinction among three different kinds of problems in the world: the simple, the complicated, and the complex. Simple problems have neatly consistent logical processes, like baking cake from a mix. Following the recipe brings a high likelihood of success. Complicated problems require a multitude of people, props and specialised expertise to solve – like sending a rocket to the moon. Timing and coordination become vital to success. Complex problems are often unique, and while experience may provide expertise, it does not guarantee success. An example of a complex problem is raising a child. A key feature of complex problems is that their outcomes remain uncertain (probabilistic at best).

Money management probably lies on the spectrum between a complicated and a complex problem. While there is no handy step-by-step guide for confronting complexity, it may be helpful keeping the following general ideas in mind:

Firstly, while complex problems at not linear, they often embed trade-offs. Trade-offs invariably mean conceding something for something else. In the money management business, the trade-offs are well known and run along the lines of potential return against the risk of loss. What makes it complex is that outcomes cannot be known ahead of time.

Next, a key part to dealing with complexity is deciding what is important and what isn't – it makes the task of weighing up trade-offs more concrete. Often solutions to complex problems benefit from constraints – what are the non-negotiables, for instance.

Finally, accept what is likely in your frame of understanding and what is not. Like the unrequited expectations of many market pundits during the pandemic, the market never quite complies with our expectations – at least not over a short time horizon. The more accepting we are of the complexity of the market, the better able to identify and optimise for those elements that are in our influence.

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Graph 2: S&P 500

Change in price level of S&P500 Index (y-o-y)
S&P500 Index [RHS]
S&P500 Index 1 year earlier [RHS]

SOURCE: IRESS Data

If we are to learn anything from 2020, we should learn that the world is still complex.

Afterword

For readers interested in a longer-term view of the S&P 500's annual price change, Graph 2 illustrates the time series over the past decade. In the last 10 years (or 2,870 trading days), the Index traded below its level from a year earlier for 295 days (or 10% of the time). The events of 2020 did little to alter the trajectory of this market, but it has been a more tumultuous year than we've become used to. ■

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. He is also joint-Portfolio Manager of our House View Equity portfolios. 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.

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iStock-469535168

The active return journey continues

Valdon Theron
HEAD OF INSTITUTIONAL BUSINESS

KEY TAKE-AWAYS

- *When analysing a fund's return performance, it's important to use rolling periods of return, rather than a simple "point-in- time" return period, such as five or 10 years, as the latter is an arbitrary period that says little about the consistency of a fund's behaviour through different market cycles.*
- *Although Prudential's more recent relative equity performance has been disappointing, a look at rolling periods over three years and longer shows the Prudential Core Equity Composite has continued to beat its benchmark consistently.*

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In a previous article, The active return journey (***Consider this Q1 2019***), we proposed that investors should analyse a fund's returns relative to benchmark (active returns) on a rolling basis. We argued that this provides investors with a far more complete picture than the most popular method of looking at a fund's active returns, whether it be over 1 year or 10 years, at a single point-in-time. Analysing active returns in a monthly sequence provides more data points and allows investors to see how a fund has "behaved" over various investment cycles. When, and how, was outperformance delivered? To what degree of consistency, i.e. the frequency by which it has beaten its benchmark over various rolling return periods?

A key take-away from the previous article, where we analysed the performance of the Prudential Core Equity Composite up until 31 December 2018, was that over shorter time periods, such as rolling 12-month and even 36-month periods, underperformance can and does happen. However, Prudential has been able to consistently beat its benchmark over longer periods, for example five years and longer, by compounding more gains than losses against the benchmark over the shorter term.

The last 18-24 months has undoubtedly been a disappointing period of relative performance for investors in Prudential's equity portfolios. This on top of below-average equity market returns, or beta, which is outside of our control in a fully invested equity portfolio.

Graph 1 shows rolling 12-month active returns (vertical grey bars) for the Prudential Core Equity Composite since its inception in 2004. This is an aggregation of all the institutional portfolios we manage using our specialist Core (Houseview) equity process. After a particularly strong period of outperformance over 2017 and 2018, 12- month rolling active returns have largely been negative in the ensuing period.

Despite the recent downturn in active returns, the since-inception outperformance of 1.3% per annum remains very attractive. This means that over the 16-year tenor of the

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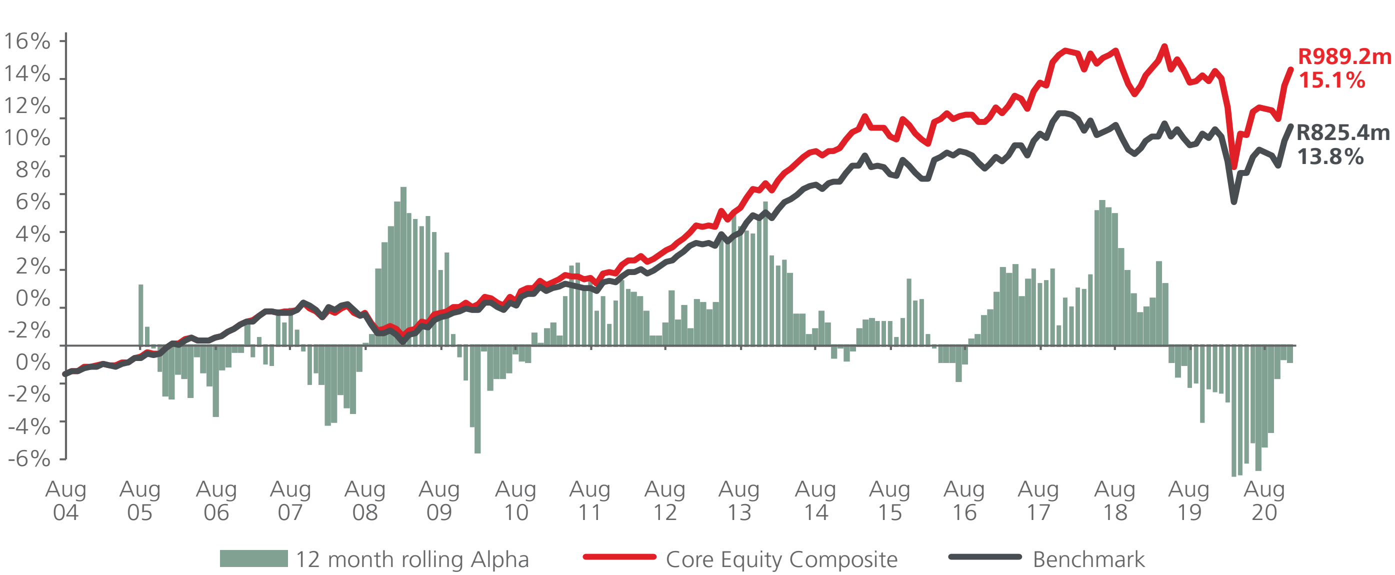
Prudential Core Equity Composite, a R100 million investment would have grown to R989 million (gross of fees), compared to R825 million for a similar investment in the benchmark.

While underperformance in the short term is not unusual, we do assess ourselves on a continuous basis. A superior long-term track record is ultimately achieved by the "wins" outweighing the inevitable "losses" against the benchmark over shorter time periods. An assessment along the following lines can prove particularly useful to our clients after a period of underperformance against the benchmark:

- What has caused the underperformance?
- Was the underperformance caused by any change to investment philosophy or process?
- Has the underperformance affected the long-term performance track record or consistency profile?

Graph 1: Prudential Core Equity Composite

Performance as at 31 December 2020



Source: Statpro & Prudential Investment Managers

*Market value weighted blend based on the underlying fund benchmarks within the composite, it consists of the FTSE/JSE Shareholder Weighted Index and FTSE/JSE Capped Shareholder Weighted Index.

SOURCES: Statpro, Prudential Investment Managers

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Key detractors from recent relative performance

In Prudential's equity portfolios, key positions that detracted in the shorter term include overweight positions in Sasol, Sappi and banks, and underweight positions in the gold sector. A lot has been written previously about our original investment cases and current views on these stocks, so it won't be belaboured here. Suffice to say, we have been on the wrong side of some fairly significant price action in these stocks over the past 18 – 24 months. For example, Sasol halved in value over the course of 2020, while the gold sector gained 35% (and was in fact up more than 100% at one point during the year).

Unchanged investment philosophy and process

We continue to follow the same team-based and prudent value approach to investing. Specifically, there has been no change to our internal risk limits, for example allowing a maximum 4% over- or underweight position in a stock against the benchmark. However, unusual about the recent period has been the high correlation between under-performing positions, and the extent of price moves in these. For example, even a relatively modest average overweight position of 1% during 2020 in Sasol (noting higher active positions at certain points during the year) detracted 1.4% from relative performance given the poor price performance of the stock.

Consistent delivery of outperformance over the long-term remains intact

Graph 2 depicts the Composite's active returns over longer rolling periods to 31 December 2020, and confirms how it has still beaten its benchmark 86% of the time over rolling three-year periods, and a full 100% of the time over both rolling five- and 10-year periods.

The recent negative performance cycle has naturally pulled down the level of active returns over all rolling time periods; however, Prudential's track record of beating its benchmark with a high degree of consistency remains intact over longer, more meaningful investment periods.

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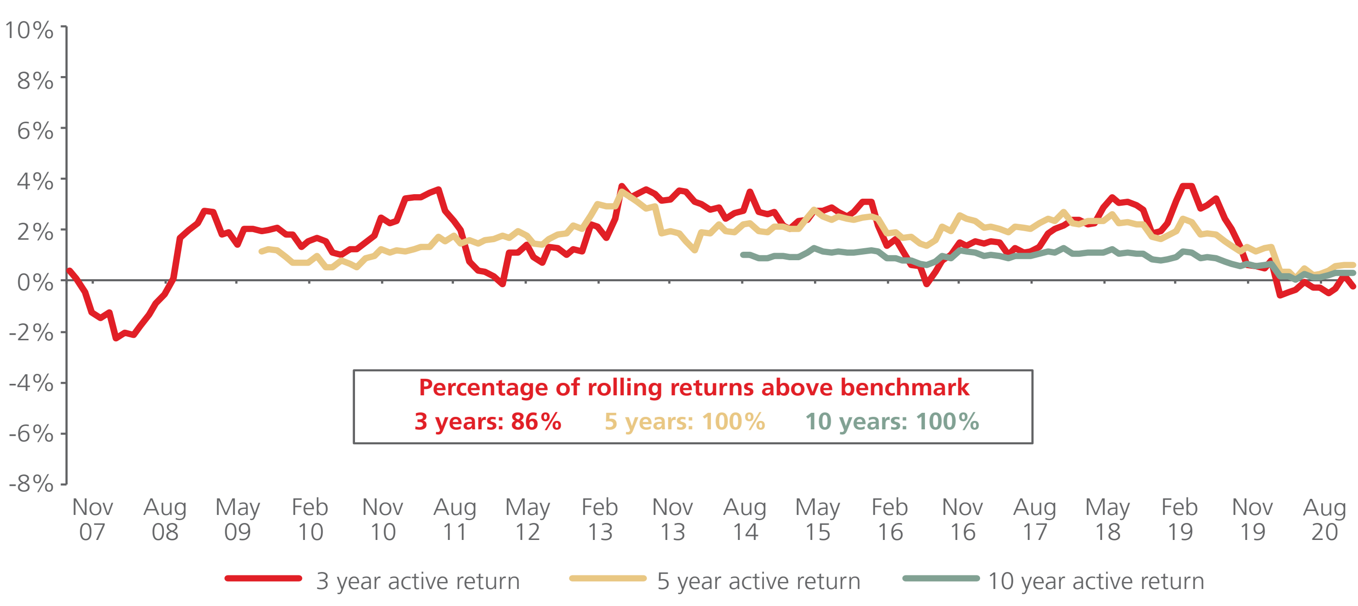
These "hit rate" statistics make a compelling argument for Prudential's ability to deliver consistent outperformance over the long term.

The active return journey never stops

Performance cycles, negative and positive, are par for the course in active investing. We continually devote much time and effort to interrogating our performance outcomes – whether good or bad – and attempt to place them in a more holistic context by, for example, looking at rolling returns over longer time periods.

Investing is a continuous and forward-looking endeavour. We remain excited about the valuations of many companies which have the potential to deliver outperformance to our clients' portfolios – and see us adding more "good months" to our rolling returns. The last three months have provided early, albeit very short term, signs of this as some of our long-held positions, for example in banks, have started performing well.

Graph 2: Prudential Core Equity Composite has outperformed consistently over 3 years and longer



SOURCES: Statpro, Prudential Investment Managers

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Our clients can take comfort that through all of this, we remain committed to our prudent, valuation-based approach to investing. This has yielded superior returns to investors over the long term, exemplified by the number-1 ranking over 10 years (the longest measurement period) of the Prudential Core Equity Composite in the Alexander Forbes S.A. Equity Manager Watch™ survey (benchmark-cognizant category) as at 31 December 2020. Of course this a point-in-time measure that we urge investors to be cautious about, but it is equally an industry standard. ■

Valdon joined Prudential in 2009 and was appointed as Head of Institutional Business later in the same year. He is responsible for managing relationships with all of Prudential's institutional clients and is also a member of the Prudential Investment Managers (SA) (Pty) Ltd Board. Prior to joining Prudential, Valdon held a similar role at Investec Asset Management. He has a wealth of experience, having started his career in the insurance industry in 1996 where he worked in various areas, including: actuarial valuations, product management, marketing and strategy. In his spare time, Valdon enjoys spending time with his family and friends, working on his golf swing and playing fives football.

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$(1.00)^{365} = 1.00$

$\mathbf{(1.01)^{365} = 37.8}$

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The Investment Risk Manager's Toolkit

iStock-1176100531

CLARE LINDEQUE
HEAD OF QUANTITATIVE ANALYSIS

KEY TAKE-AWAYS

- *Strong investment risk management is vital in delivering the portfolio returns expected from a fund.*
- *The many tools involved in risk management include not only different types of computer data analysis, but also continuous personal interaction and independent interrogation.*
- *Prudential's risk management approach is to "spend" a fund's total risk budget on investment ideas in which they have the highest conviction.*

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In addition to the catastrophic changes it effected on almost every aspect of our lives in community as humans, the Covid-19 pandemic caused massive disruption in the world's financial markets. As the economic effects of the pandemic, both immediate and projected, began to be processed by market participants and the actual numbers to reflect in economic and higher frequency data, remarkable volatility in the price of almost every asset class characterised the months of March and April 2020 in particular. For many people, the risk – rather than just the return – of their investments was, perhaps for the first time, front of mind. The risk I refer to here is the risk that is broadly associated with prices moving up and down. There are associated effects (such as ratings downgrades, liquidity changes, and the likelihood of reaching performance targets) that flow from price volatility and changes in the economic climate. It is an investment risk manager's job to think about these sorts of risk.

A question of independence

The risk manager role differs across firms; at Prudential, investment (or market) risk measurement and reporting is a function that sits inside the investment team, while most other risks (e.g. operational, business and strategic risk) are monitored by the compliance team. There are advantages of positioning investment risk within the team of investment professionals (traders, portfolio managers and analysts) who make and execute investment decisions.

> **"For many people, the risk – rather than just the return – of their investments was front of mind"**

Information about portfolio risk can be both quickly gathered, and quickly fed back into the investment process, enabling careful calibration of active positions, and nimble adjustments to portfolios whose risk characteristics become a concern. Regular conversations within the investment team about market risk facilitate improved literacy around market risk measures and empower portfolio managers to discuss and act upon market risk information. They also cultivate trust between the risk management function and the rest of the investment team, which

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is particularly useful during times of market stress, when the risk manager may have to ask difficult questions.

An objection to positioning the investment risk function inside the investment team rather than as a middle-office function, perhaps alongside the performance reporting team, is that independence – which is vital to ethical and accurate risk monitoring – is potentially compromised. A risk manager who sits alongside the investment team cannot help but hear, and even buy into, the narratives that are associated with trades or strategies deployed by the team. It is the risk manager's job to dispassionately evaluate risks, and even the appearance of bias or a lack of objectivity can be damaging to the integrity of the role and should be a source of concern to senior management.

To address this shortcoming while still enjoying the previously mentioned benefits of the market risk function being close to the investment team, it is vital that there is independent oversight of portfolios' investment risk characteristics and trends. Keep reading – I'll shortly tell you more about how we handle this at Prudential.

An investment risk manager needs strong numerical capabilities and a sound grounding in the fundamentals of mathematical finance, but also the ability to communicate complex information clearly, and as simply as possible without misleading. While many introverts may raise their hands after reading the first part of this description, it is important that a risk manager not be such an introvert that they fail to speak to the humans taking the very risks that they are trying to monitor and manage. In addition to giving feedback both to portfolio managers and senior management on what risks are evident in the portfolios, this communication also entails extracting and synthesising information from members of the investment team and other parts of the business (more on that in a moment).

What tools should an investment risk manager have available to do all this?

Ex-ante risk measures

Let's get this one out of the way first. It is tempting to imagine that, with the aid of incredibly sophisticated mathematical tools embedded in shiny software systems, investment risk managers are able to push a button, print out a report that covers all

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possible forecast risks, send an email and clock off for the day with an air of smug satisfaction.

While we do have extremely complex systems available to estimate the risk contribution of every single instrument in a portfolio, using these systems is only one component of investment risk management. But first – what do these systems do?

Early practitioners of mathematical finance and econometrics realised that equity returns could be explained in terms of exposures to underlying factors – such as to the market itself (the classical "beta" you might be familiar with), to large or small market capitalisation stocks, to value stocks, and so on. If returns can be described in this way, so too, with a little bit of matrix algebra, can risk, in the fairly narrow sense of volatility or standard deviation. This insight has extended across multiple asset classes and factors, and has allowed the construction of "risk models", which are essentially giant matrices that describe how assets move in relation to one another (called covariance).

This covariance matrix is the heart of every risk model. It is possible to build one's own risk model, but typically firms such as Prudential, with large and relatively complex asset class investments, choose a provider and purchase their tools. The interface to the risk engine may be Cloud-based (this is increasingly common), or via a standalone piece of software. The only inputs required are the portfolio and benchmark holdings on the day for which you want to estimate risk.

The outputs of most risk engines include the contribution of each instrument in the portfolio to the portfolio's active (i.e. benchmark-relative) and total risk. It is common to aggregate these risk contributions up to sector level for equities, for example, or into duration or credit ratings buckets for fixed income instruments, or by region or currency for funds that cover multiple geographies. Active risk is commonly known as tracking error (this is the standard deviation or variability of the portfolio's active returns), and in contrast to the tracking error numbers reported after the fact (such as on fund fact sheets), risk models give an estimate of forward-looking, or

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ex-ante, tracking error. But how is this possible?

A fundamental assumption of the risk models I am describing - one that is both necessitated by there not being much in the way of alternatives, and that makes forward-looking risk estimation possible - is that the way assets have recently co-moved, is a "good enough" guide to how they will move in the immediate (3-12 month) future. The covariance matrix is constructed using asset class return data looking back over a few years (3-5 years is common) but weighted in such a way that recent returns carry more significance than returns from a few years ago. Some matrix algebra – a more complex cousin of linear regression – combined with just the current portfolio and benchmark holdings, gives ex-ante risk contributions that depend only on those inputs. Usefully, these forward-looking risk numbers are actionable; if the portfolio manager changes his portfolio holdings, the ex-ante tracking error and total risk of the portfolio will change immediately.

There is no single way to build a risk model. Each one is the product of extensive and ongoing research and development, and requires regular (usually daily or monthly) updates to reflect new market data. Different risk models from different providers give different risk numbers; while it may seem like a failure to have more than one tracking error estimate for your fund, it is extremely useful to draw comparisons and to look at multiple risk models to get a more complete picture of what is going on. At Prudential, we run two risk models in parallel for our equity investments, as the most volatile asset class.

"As a rule, one would like to 'spend' one's risk budget on the ideas in which one has the highest conviction"

What do we use the tracking error estimates and contributions for? Within the investment team, the most important use of the output from our risk models is risk budgeting. As a rule, one would like to "spend" one's risk budget on the ideas in which one has the highest conviction (i.e. we prefer our highest tracking error contributions to come from those assets from which we expect

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the best future returns). Conversely, one doesn't want to embed a view – a risk – in a portfolio by accident, as a result of aggregating multiple active positions. As we are bottom-up investors at Prudential (e.g. selecting individual stocks rather than whole sectors), this is something that we monitor closely.

Outside the context of investing, mandates require that we monitor and control the tracking error of some of our portfolios (for example, the Prudential Enhanced Property Tracker Fund is required to have a tracking error of less than 2%). We also have internal risk limits, against which we monitor all our portfolios.

Other risk measures

Not all risk measures require an expensive risk engine to produce. Some of the simplest ones remain extremely useful both to risk and portfolio management. Examples are active share (a pure measure of activeness – or how different the portfolio is from its benchmark - calculated using the portfolio and benchmark weights) and the various duration measures that are the stalwarts of the fixed income world.

Stress testing

The risk models described above have other uses than simply producing tracking error and total risk estimates; they are also good for stress testing (or scenario analysis) of portfolios. Stress testing enables us to look at "what if" scenarios such as, what returns might have been generated if we had had our current portfolio positioning during the unravelling of the IT bubble in the early 2000's, or during the SA-specific turmoil of Nenegate, or if the rand were to weaken against the US dollar by 10%. We stress test our portfolios against both a standard set of historical and hypothetical market scenarios, as well as any events that the investment team feels they might be particularly vulnerable to. The results of stress tests enable the investment team to calibrate the amount of risk taken in particular positions or portfolios, and to weigh the portfolio's vulnerability to different types of market moves, against their investment ideas and convictions.

Trend analysis

In order to set and enforce risk limits, it's important to have a sense of what is "normal". For this, analysis of long-

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term trends in market risk-taking by the investment team is very useful. One of the two risk models we use for equities has been in use at Prudential since 2002 (with enhancements from the vendor). This gives us a long and detailed time series of risk numbers against which to contextualise current portfolio positioning. Because different risk models give different tracking error estimates, often the trend will deliver more insight than a spot estimate.

Monitoring of portfolio fundamentals such as yield, price-to-earnings and other accounting ratios adds a further layer of understanding when combined with tracking error and other holdings-based risk estimates. Deviation from longer-term trends with respect to these measures can signal several things (including, for example, a change in the opportunity set such as in the immediate aftermath of a crisis, where there are many buying opportunities). It is important to interrogate such changes from a risk management perspective.

Talking to people

A surprisingly large part of the risk management function involves talking to colleagues. As a rule, my team does not participate in portfolio management or investment decision-making meetings, and it is therefore useful to have portfolio managers or analysts explain the investment rationale behind their decisions. This information can be compared to and tested against the quantitative information that I have from looking at the portfolio from the outside using a risk model and other tools. In each case, I am trying to understand, what is the reference narrative? What could go wrong? How can we test those outcomes? (Which brings us back to stress testing!)

The trading desk holds a wealth of useful information for risk management purposes. There are many limitations to numerical estimates, and, for example, a conversation with the traders along the lines of "how long do you think it would take to trade this much of this instrument?" is an essential adjunct to any quantitative estimate of liquidity. The average person probably doesn't know that it can take multiple days to complete a large trade of a smaller company's shares in the local equity market – think of the risk involved resulting from intervening news and share price changes during the trading time!

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Independent eyes

I have mentioned how important it is for the risk management function to either report to, or be, an entity that is independent from the investment team. At Prudential, an independent risk oversight committee (with members who are not part of the investment team) regularly meets and reviews detailed investment risk data. The committee also consults with the heads of the departments within the investment team (equity, fixed income, multi-asset), and draws in information and feedback from multiple business areas to form as complete a picture as possible. The committee's deliberations and recommendations are ultimately reported to the board.

"Without strong risk management, it would be impossible to deliver the returns our clients expect from us over time"

If one had to boil down an investment risk manager's job to its essence, it is to be constantly asking "What is going on here?". I spend a lot of my time pursuing this question down rabbit holes of quantitative data and asking questions of long-suffering colleagues on the trading desk, in the performance team, in compliance, in the data management team, and within the investment team itself. Then I synthesise and distil this information to feed back to investment team members, and to present to the oversight committee. It is a fulfilling role, and, more importantly, one that is vital to the disciplined functioning of the investment process. Without strong risk management, it would be impossible to deliver the returns our clients expect from us over time, through the ups and downs of financial markets. ■

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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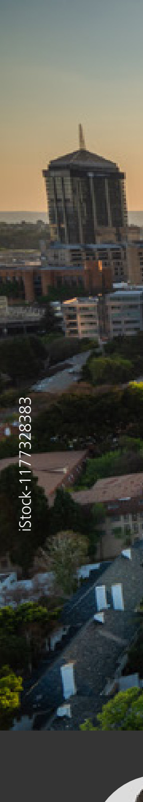

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SA's corporate credit market bounces back

DUNCAN SCHWULST
CREDIT ANALYST

KEY TAKE-AWAYS

- *From a virtual standstill in April, the local credit market has rebounded surprisingly well, with good levels of supply and investor demand.*
- *Despite credit rating downgrades and a contracting economy, most companies have found flexible funding sources and been able to renegotiate borrowing terms if necessary.*
- *Today's higher borrowing costs reflect the higher risk involved, and Prudential thinks investors are being adequately rewarded for those risks. but otherwise the scars from the Coronavirus market crash are few.*

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It was a rough ride for participants in the local credit market in 2020, through which companies can borrow to finance their operations, and investors like Prudential can (usually) benefit from lending to them. With the onset of the Coronavirus crisis and uncertainty surrounding economic growth, the market ground to a virtual standstill in the second quarter of the year, and prices were not being adjusted accurately. This we discussed in our article "Fairly valuing corporate bonds for our clients" (Consider this, Quarter 3 2020). Along with the pandemic came a string of bad news around the prospects for both global and local economic growth, and more sovereign credit rating downgrades for South Africa. Risk levels appeared extremely high.

Yet the good news is that the year has ended surprisingly well for the corporate credit market - despite all the disruption, issuance has resumed and is even encouragingly active. We have seen companies of different credit risks being able to raise debt again and investors willing to invest. But is this too good to be true? Are the risks being accurately reflected in pricing for company debt, or are investors not being adequately compensated for holding it? Are there attractive deals to be had? Below we examine key aspects of the market to give investors insights into the risks – and rewards – now presenting themselves.

Debt issues revive with enthusiasm

As we have seen in the past, such as during the Global Financial Crisis, liquidity and deal flow in the local credit market tend to dry up during episodes of financial stress. This was certainly the case in the months following the onset of the Coronavirus pandemic in South Africa. Graph 1 shows how cumulative new credit issuance came to a virtual standstill for the period March to May. What is also evident from Graph 1 is the gradual recovery in issuance levels through the end of November, where the rate of new issuance (as seen by the slope of the grey line), is almost on par with that of 2018. Investors are again comfortable to lend to companies, and corporate borrowers to take on more debt. Still, it appears as though total issuance for 2020, at around R100 billion or so, will be far lower than the roughly R170 billion seen in 2019.

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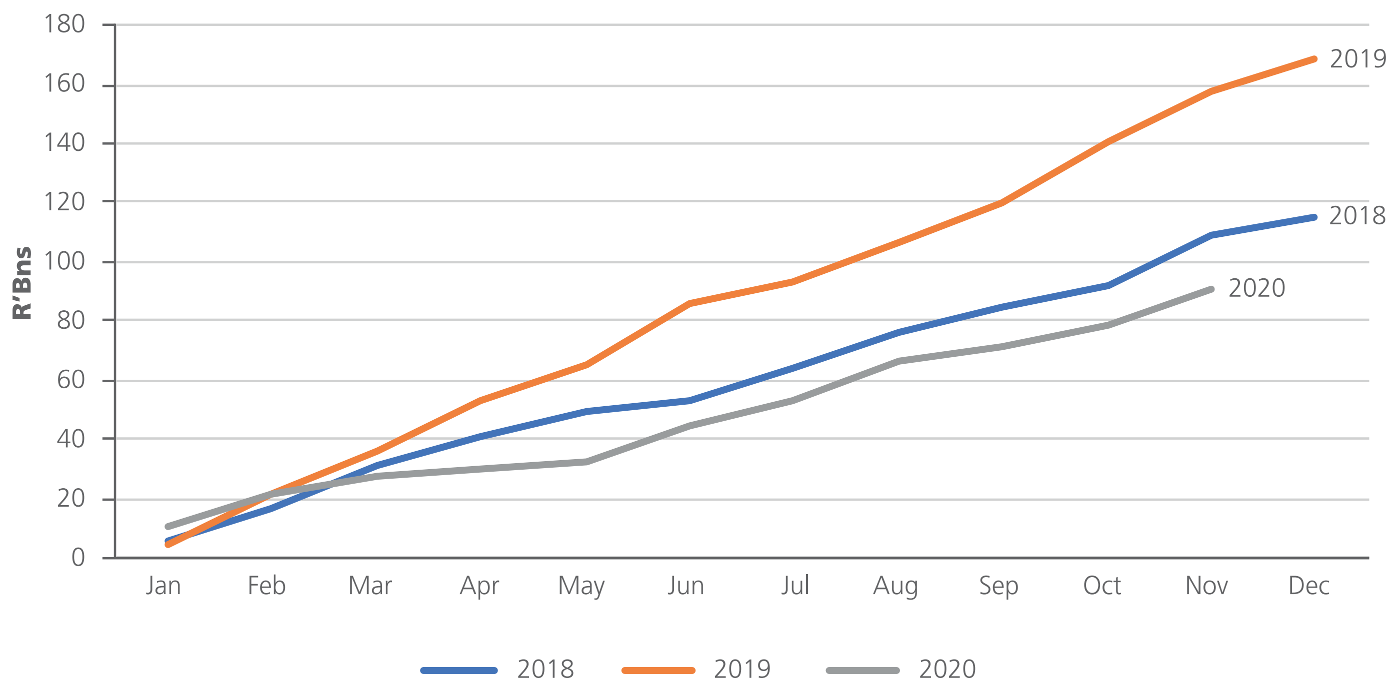
Graph 1: Cumulative annual listed credit issuance



SOURCE: RMB, Prudential

Another sign of the impact of the pandemic was seen in the absence of public auctions of new debt. Instead, companies preferred to conduct private placements of debt on a bilateral basis or, where there was a bit more demand, with more than one investor (see Graph 2). These deals, concluded behind closed doors, were preferred by issuers as they allow for price discovery away from the eyes of the market. If a company did not like the pricing being offered, it could walk away without the stigma of having held a failed (public) auction, where not all of the debt it wants to issue is taken up, or the price is driven up substantially. More recently, as the South African economy has opened up and confidence has returned to the market, more public auctions have been taking place (as shown in Graph 2), deepening investor participation in price discovery.

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Graph 2: Private Placement or Public Auction?

SOURCE: Prudential

Corporate financing options

So how have companies sought to deal with the financial stresses brought about by the pandemic, and the lack of activity in the debt capital market? One of the initial actions many corporates took was to access their undrawn bank debt facilities, with already-approved terms, that they can ordinarily draw down over time. Not only did this provide instant liquidity for balance sheets, it also addressed the risk that under severe financial distress the banks may decide to not stand by these undrawn facilities. A further action taken by many corporates was to put additional committed bank facilities in place. These provided an extra source of emergency liquidity. Although these facilities come at a price in the form of commitment fees, this is a price corporates are willing to pay if it helps them weather the crisis, even if the facilities are not always utilised.

Given the lack of activity in the credit market, and companies' concerns

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around the elevated cost of funding in the market at the time, unutilised bank facilities were in many cases used to repay maturing listed debt in the corporate bond market. This saw maturing listed debt not being rolled over, but rather replaced by unlisted bank debt. Corporates would prefer to do this than raise new debt at higher credit spreads (or higher default risk premiums), effectively setting a new, much wider, marker for where their debt should price. The strategy was to rather sit out the period of market stress and re-enter the market once conditions were more conducive and credit pricing moved lower, closer to past levels. Where companies have opted to access the debt market, there has been a preference to issue for a shorter term. Doing so ensures that an issuer does not lock in higher funding costs for too long. Shorter-term debt may also be attractive to investors who have concerns about the longer-term outlook for an issuer, although it can be argued that with Covid-19 the risks are, in any event, heavily weighted to the near term.

Renegotiating terms

Unsurprisingly, the impact of Covid-19 and the lockdowns on business activity has weakened most companies' financial health. As a result, several corporates across different industries were faced with the prospect of potentially breaching, or at least getting close to breaching, borrowing covenants. This led to a number of them approaching their lenders to temporarily waive covenant-testing or relax covenant levels. In the listed bond market the most notable example of this was property group Redefine, which asked debt holders to relax their loan-to-value, or LTV, ratio covenant from 50% to 55%. Interestingly, they did not offer any additional compensation, such as paying an increased interest rate, for this indulgence. Prudential's view in this case was that by increasing the LTV covenant level, investors were being asked to accept a higher risk than what had been the case when the debt was initially sold to investors, and as a result a higher level of compensation for taking on this risk was warranted. Despite Prudential voting against this change to the debt terms, the resolution passed overwhelmingly. This was no doubt helped by the fact that the majority of noteholders who could vote had the benefit of security

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over fixed property assets, and were thus less sensitive to a deterioration in Redefine's credit risk, as evidenced by the higher LTV.

Banks come to the party

During the Covid-19 period, the types of company debt issuance, in terms of sector exposures, have been broadly in line with historic trends. By far the largest amount of issuance has come from the banking sector, as highlighted in Graph 3. One might have expected that in the Covid-19 environment the investor appetite for bank risk would have been limited to lower-risk senior debt, but we have actually seen a number of banks also being able to raise subordinated debt (both tier II and the even riskier additional tier 1 bonds). However, credit spreads did move wider for this riskier subordinated debt as investors did demand higher risk premiums.

Why were investors happy to take on higher-risk bank debt? Despite the severe impact of the lockdowns

Graph 3: Issuance by sector – Mar-Nov'20

Rm's
20 000
18 000
16 000
14 000
12 000
10 000
8000
6000
4000
2000
0
Autos
Banks
Banks (Nam)
Construction
Div. Ind.
Hospitals
Insurance
Manufacturing
Medical
Metro
Mining
Motor
Personal loan
Property
SOE - Finance
SOE - Infrastructure
SOE - Power
SOE-Manufacturing
Telecoms

SOURCE: Prudential

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on the South African economy, local banks entered this crisis in a stronger position than at the onset of the Global Financial Crisis. Capital levels are higher and new liquidity requirements have also strengthened balance sheets. In addition, government interventions aimed at taking risk alongside the banks, to assist distressed borrowers, have helped to prevent any local financial crisis that could have arisen as a result of the withdrawal of credit. For example, in June Standard Bank issued Tier II subordinated debt via an auction at a spread of 3.75% compared to 2.15% before the crisis. At Prudential we decided to take advantage of this additional compensation and managed to add some of this attractively priced paper to our client portfolios. Read more about the local banking sector's resilience in Stefan Swanepoel's article "COVID-19 and SA banks: Recovering from the lows" in this edition of *Consider this*.

Attractive corporate pricing

Outside of bank issuance, Northam Platinum is one corporate that has been a particularly active issuer this year. Since April Northam has placed R5.9bn of debt in the market, all via private placements. The debt has been used to replace preference shares (guaranteed by Northam) issued by Zambezi Platinum, Northam's BEE shareholder. Platinum group metal (PGM) producers have benefitted significantly from the tailwind of strong PGM basket price growth over the last 24 months – the PGM basket price having risen nearly 200% (see our article "PGMs shine in lacklustre SA equity market" in the last edition of Consider This). This has substantially changed the economics of mining PGMs, and although mining commodities will always be high-risk, cyclical businesses, the near-term outlook is encouraging for them. Given the positive outlook, we participated in Northam's private placement debt bookbuild in November, adding the paper to several of our client funds which we are confident will add value.

Another company we supported recently was Super Group. Despite being impacted by Covid-19 in its European Supply Chain business and vehicle dealerships (both in South Africa and the UK), its net-debt was only marginally higher at June 2020, helped by working capital inflows. The decline in its operating cash flows had also not been severe, and there was

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a fair amount of headroom relative to its debt covenant levels. We also took comfort from the adequate cash available to cover the group's next 12 months of maturing debt.

Having said that, at Prudential we were still sensitive to the risks of second-wave lockdowns in Europe affecting the Supply Chain business and the UK Dealerships business. Likewise, the SA Dealerships will face headwinds from the weak South African economy and the risk of our own second wave. When Super Group approached the market in November to raise debt, the pricing represented a premium of 0.85% over comparable senior bank debt costs. Contrast this to a year earlier when Super Group raised three-year debt at 0.30% above three-year bank borrowing costs. In our view, we were being offered adequate additional compensation for the risks. We participated in the auction and received an allocation of this Super Group debt.

Banks getting cheaper risk pricing

Besides the increase in bond auction activity in the latter part of the year, another bullish signal was observed in the pricing of senior bank credit risk, as seen in the tightening yield spreads of bank negotiable certificates of deposit (NCDs), demonstrated in Graph 4. After an initial widening in March and early April, it was interesting to note the spreads trending tighter from late May to the end of September. Given the challenging environment and impact of Covid-19 in elevating the risk of credit losses in bank lending books, this reduced credit risk pricing for banks appeared counterintuitive. However, the primary driver of this spread tightening has been the banks' reduced requirement for debt funding. On one side banks have understandably been cautious about extending lending amid the uncertain conditions brought on by Covid-19. On the other, government interventions to assist in the extension of credit to borrowers affected by the pandemic, as well as actions by the South African Reserve Bank (SARB) aimed at easing liquidity in the financial system, have meant that banks have been flush with cash. As a result, banks have not required much funding, and the fall in spreads on their NCD's across the second half of the year reflected this. This fall in bank spreads does challenge the prospective returns available to

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investors in money market and income funds who have been accustomed to significantly higher compensation from these bank instruments over the last five years. This tightening dynamic did reverse to some extent in December, with NCD rates rising to near their pre-Covid levels.

Overall, we are encouraged by the improvement in activity levels in the credit market and we would expect further improvement in issuance levels after the usual lull in activity in January 2021. The levels of compensation for default risk (the credit spread) did move wider during 2020 (except for banks as explained above), but given the impacts of Covid-19 and the uncertain outlook for most issuers, these adjustments have been fair in most circumstances. For the most part, there has been an absence of obvious bargains for investors to snap up.

Currently, the implications for investors are that a measure of caution needs to be applied in assessing credit market opportunities. The evolution of the Covid-19 pandemic is still highly

Graph 4: SA Bank's 3-year NCD rates

SOURCE: Bloomberg, Prudential

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uncertain. Further waves of infections, and responses to contain these, still need to play out. And as for the vaccines, developments offshore are encouraging, but their arrival and roll out in South Africa will still take some time. Even then, once the dust has settled there are bound to be longer-lasting changes to the functioning of our economy which will impact many businesses. As always, we will continue to look for opportunities that provide a margin of safety to guard against the downside risks. ■

Duncan joined Prudential in 2007 as a Fixed Income Credit Analyst and was appointed as joint-Portfolio Manager of the Prudential Enhanced SA Property Tracker Fund in December 2014. In June 2018, Duncan returned to the Fixed Income team to resume his role as Credit Analyst. His responsibilities involve focusing on various sectors, including property company debt issuers. Prior to joining Prudential, Duncan completed his articles at PwC, after which he took up a finance role at JP Morgan in the US. His qualifications include a BBusSc in Finance, Post-Graduate Diploma in Accounting, CA (SA) and CFA.

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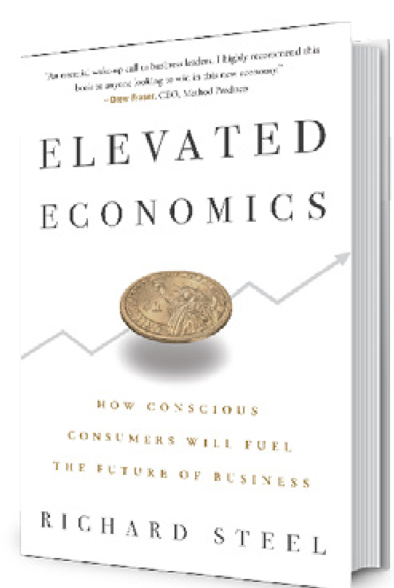
Conscious consumerism: Driving business change for the better

Miranda Van Rensburg
REGIONAL SALES MANAGER



"As business leaders, the new economy has brought each of us to the most significant inflection point of our careers. Don't miss it." – Richard Steel.

You cannot profit from a dying planet. As per the New York Times of 12 June 2018, "Earth will survive. We may not". *Elevated Economy* charts a course for business leaders who have realised the magnitude by which the consumer today is demanding change and who want to equip their businesses for survival in this new economy. It is written by Richard Steel, an alumnus of Harvard Business School and adviser to the White House Business Council.

While the book is focused on business leaders, the trends and challenges identified are relevant to the world that all of us face. Steel's writing style allows for easy reading. The book starts off by highlighting the change in the demographics of today's consumer. It is this consumer who no longer buys based on product, price, place and promotion – this consumer has also included a fifth "P" which refers to Purpose. This new consumer is building a new economy, one that is driven by a desire to improve rather than just produce.

Steel interviewed many business owners as part of his research and includes many examples of actual businesses who have been doing good – practical

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implementations throughout the supply chain. The book is aptly titled Elevated Economics as it is all about a change in demand (driven by the new consumer) through a commitment to environmental and social goals, while still making companies more profitable. Steel refers to when Harvard Business School was created, during which Dean Edwin Gay said that "the purpose of business is to make a decent profit decently".

The author incorporates interesting statistics throughout the book. Statistics such as the fact that Starbucks spends more on their employee benefits than they do on coffee, emphasises that success is greatest when shared. There is reference to numerous applications in business, such as Adidas's initiative to manufacture a sports shoe from recycled plastics that came from contaminated oceans. The author ascribes Elon Musk's success with Tesla not simply to the fact that "he gave consumers the chance to buy a new car, but a chance to buy a car that could save the world". In the US, Kentucky Fried Chicken has recently unveiled an experimental menu with items that contain no chicken, but are instead plant-based .

It comes as little surprise that the new consumers of the *Elevated Economy* are the Internet-enabled Millennials and Generation Z beneficiaries of the "Great Wealth Migration". In this wealth migration, it is estimated that about 45 million US households will hand down about $68trillion over the next 25 years and the same will happen elsewhere in the world. This migration gives these new generations considerable power to demand not only that companies make a positive impact on the world around them, but also that companies involve their customers in their good work by allowing them to give back.

Much has been written about artificial intelligence that will presumably push people out of the job market. Steel points out that "it is in this environment that there is a growing need for businesses to establish themselves as forces for good, worth protecting for our collective future". He eloquently points out that "being a change agent in this new elevated

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economy doesn't require a company to be perfect. It requires a company to be trying".

Succeeding in business requires consistent humility. Steel proposes that there are four cornerstones that companies have to incorporate if they wish to survive in the new Elevated Economy: diversity and inclusion, pay equality, impact in the community the company operates in (rather than simply making donations to a charity), and building a brand based on "values, not value".

Closer to home, we at Prudential together with the rest of the broader investment world have certainly been made aware of the demands from the new customer when looking at the number of funds now run on the principles of impact investing. Investors are increasingly scrutinising how asset management firms are incorporating environmental, social and governance (ESG) factors in their investment philosophy. Already in 2019, net inflows into US sustainable funds totaled $21bn. Inflows into such ESG funds are expected to reach $100bn per year. We are excited about the possibilities that this brings about, also in our own economy.

In his concluding chapter, Steel points out that the next few decades of economic progress "doesn't just have to be great .. it can also be good" which aptly describes what is possible if we look after our planet and each other. This book serves as a testimony of what is possible when leaders step up to a challenge. It should not be seen as a doomsday prophecy. In the words of Walt Disney when he opened Disneyland in 1955,"to all who come to this happy place, welcome". ■

Miranda joined Prudential in January 2016 as Regional Sales Manager. She is currently responsible for the management of retail distribution in the Gauteng region. With more than 20 years' industry experience, Miranda has served in a range of roles including: business development, manager research, portfolio management and asset consulting to large pension funds. She holds an MSc (Engineering) degree and is a CFA Charterholder.

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