M&G Investments

Quarter 4 2021

Consider this

Going Global: Cash and diversified equities are tops page 16

Amid the multi-speed global recovery, very unusual conditions are resulting in equally unusual global asset allocation

Eric Lonergan, M&G Investments (UK)

FPI Financial Planning Institute of Southern Africa THE PROFESSIONAL STANDARD

1.5 CPD POINTS

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Contents

Chris Sickle
Chief Executive Officer

Letter from the CEO

The past few months of 2021 have been eventful at M&G Investments, and I am proud to be writing my first letter to you in my capacity as CEO of the business following Bernard's decision to step down and take a well-deserved break. Although I have already been working closely with him as Chief Financial Officer for the past 2.5 years, and therefore understand the business well, we will continue to share information and collaborate closely until February 2022 to ensure a smooth transition. With the support of the Board and Executive Committee, as well as all of our committed investment professionals, I am confident that M&G Investments will continue to move from strength to strength no matter what the markets might throw at us, so that we can keep delivering consistent investment success to our clients.

Another transition that we have experienced over the period is the change in our brand name from Prudential Investment Managers to M&G Investments from 15 November 2021. As we have explained in previous communications and at our official client launch, we have assumed the name of our parent company to best demonstrate our alignment within a single global investment management brand, and our greater integration with them. We are confident that this change will deliver enhanced investment outcomes to our clients, among other benefits, but you can also expect that many things will not change.

For example, our primary business objective remains to deliver excellent investment returns that help our clients achieve their financial goals. In order to do this, our single-minded focus has always been, and continues to be, on helping our clients grow and protect their investments.

We believe our closer ties with M&G strengthen our ability to do this. This is primarily through the improved integration of our global and local investment expertise across different areas of our businesses. Like many aspects of today's world, investing is becoming increasingly globalised. South African investors have more offshore exposure than ever before, and we believe our clients will be able to achieve their goals more easily through access to greater global inputs and resources.

"...our primary business objective remains to deliver excellent investment returns that help our clients achieve their financial goals."

This global expertise needs to be combined with specialist local investment knowledge, relationships and understanding of social needs to ensure the best client outcomes, which also help simplify the complexities of global investing.

Our greater access to M&G's extraordinary depth of investment resources, including hundreds of investment professionals and sophisticated AI technology, offers large scope for us to enhance your investment outcomes. Our greater global scale should also give us more impact when it comes to shareholder activism and positive ESG outcomes. M&G is already a very active global investor, having participated in the recent COP26 Climate Summit, for example.

At the same time, having a global parent of material substance enhances our ability to attract and retain high-quality investment personnel, helping team and investment performance continuity, and increases opportunities for offshore and local skills exchange.

And finally, like the range of Prudential (now M&G) Global Funds we set up in 2018 with input from our London colleagues, we can also tailor future new solutions to offer both global and local expertise.

What is not changing? You can rest assured that we remain passionate about, and fully focused on, investing -- nothing else. We will continue to put our clients first.

Our interests remain fully aligned with those of our clients. All our staff continue to invest in our unit trusts (via our pension funds, retained bonuses and dividends), and also retain material (now even higher) equity ownership in the company.

Equally, we retain our conviction in our tried-and-tested, valuation-based investment philosophy and process. We believe this is critical to ensuring consistent delivery of strong investment performance over time and through the succession of key investment personnel. And we will continue to take a team approach in building and managing your portfolios.

Last but certainly not least, we will continue to ensure our clients' investments are in safe hands and custody. Going forward we will partner with our global colleagues so that we remain at the forefront of global best practice, and retain access to the best service providers in the world.

Market developments

For details about Q3 2021 market developments abroad and in South Africa, and our latest portfolio positioning, read our latest **Market Observations** by CIO David Knee.

New contact information

I would like to remind you that we have now updated our email and website domains to reflect our new M&G Investments identity. Below are our new contact details for future reference.

Previous	New
Prudential.co.za	Mandg.co.za
Myprudential.co.za	Mymandg.co.za
query@prudential.co.za	info@mandg.co.za
instructionsa@myprudential.co.za	instructionsa@mymandg.co.za
instructionnam@myprudential.co.za	instructionnam@mymandg.co.za
instructionmg@myprudential.co.za	instructionmg@mymandg.co.za

I hope that you enjoy this "revamped" edition of Consider this, the first to feature our new M&G Investments branding. It also highlights just a few of the global investment views you now have access to through investing with us. As always, we would appreciate any feedback you may have. Thank you for your support thus far, through these changes, and we look forward to a continued successful partnership with you in the years to come.

Sincerely,

Chris Sickle

Chris joined M&G Investments in 2019 as Chief Financial Officer and took over from Bernard Fick as Chief Executive Officer in October 2021. He is primarily responsible for all aspects of M&G Investments Southern Africa's operations, including Namibia. With over 22 years of asset management experience, Chris previously worked for Ernst & Young (EY) as the Regional Managing Partner in the Western Cape and was a member of the EY Africa Executive Board. His qualifications include: B.Com Accounting (University of the Western Cape); B.Acc.Sc (Hons) (University of South Africa); Chartered Accountant (SA).

Pieter Hugo
Chief Client and Distribution Officer

Table Talk

Key take-aways

- As interest rates rise, consumers can expect to pay more for their debt, while investors should receive higher returns for cash investments. However, with interest rates starting from a record-low base, it may be some time before cash delivers above-inflation returns.
- Both nominal bond and equity returns are typically lower in a rising interest rate environment, negatively impacting on corporate profitability and government balance sheets. However, there are opportunities in assets that trade below their long-term fair value, such as select SA equities and bonds currently.

Q **The South African Reserve Bank has just increased the interest rate by 0.25%. What does that mean for me as a consumer and how will it impact my investments?**

A Changes to the interest rate can have a major impact on the financial position of most ordinary South Africans, from the amount that they pay towards their debt-financed purchases, to the investment returns that they receive from certain asset classes like nominal and inflation-linked bonds, and cash-type investments. Understanding how it all comes together is important for consumers and investors alike, as it can help them make better-informed decisions regarding their finances and investments.

But before we begin, it's a good idea to first understand where we are currently as an economy, where we've come from, and how the South African Reserve Bank (SARB) uses interest rates to manage inflation.

How the SARB uses interest rates

Interest rates typically work in cycles and are used as a mechanism for central banks to control inflation (the rate at which the cost of goods and services increases) over time. As we entered the Covid-19 pandemic, with the subsequent closure of certain parts of the economy many South Africans lost their ability to earn an income, and consequently, participate in economic activity. This placed downward pressure on the economy as a whole. To help relieve some of the financial pressure on consumers, businesses and other market participants, the SARB began reducing rates to the point where they reached their lowest levels ever in July 2020 and remained at this level until November 2021. During this time, indebted consumers were able to take advantage of this by paying off their debts, borrowing more, and contributing towards overall economic growth. Investors, however, received exceptionally low returns from their short-term investments, not even enough to beat inflation.

As the economy began reopening and employment levels increased, consumer spending continued to accelerate, but producers were slower in gearing up their supply chains, resulting in a rise in inflation from around 2.1% p.a. at the start of the pandemic to 5.0% p.a. where we are currently. Higher prices have been particularly evident in energy supplies like oil and natural gas.

To ensure that inflation remains within its target range of between 3-6% p.a. the SARB increased interest rates moderately by 0.25%, for the first time in three years, at its latest monetary policy meeting. Most economists agree that the SARB's decision was a necessary one in light of rising inflation, and shouldn't be a cause for concern. That said, consumers and investors may experience some level of discomfort (especially given the record low levels from where we come), most of which can be mitigated by having a good understanding of the effects of an interest rate hike.

Impact on consumers

When interest rates increase, loan repayments become more expensive as the rate at which the interest component of the loan is calculated rises. This isn't good news for anyone with high levels of debt, especially if you took on more debt when interest rates were at their lowest. If you could just about afford to make your repayments then, you may now find yourself struggling – especially if rates were to increase more. Given that the SARB's own forecasting model indicates a further 0.25% increase in each quarter of 2022 and 2023, now may be a good time to reduce your high-interest debts as far as possible. Or at the very least, not assume any new debt unnecessarily.

Impact on investments

Cash investments usually benefit from interest rate hikes, as banks usually pass on the SARB's increase by raising the amount investors can earn from call and fixed deposits. However, the interest rate that investors are likely to receive may still be lower than inflation, which means that the real rate of return from a cash investment will still be negative (and may remain this way for a while).

When it comes to equities, higher interest rates have a negative impact on company earnings and stock valuations. In terms of earnings, borrowing costs in the form of interest payments become more expensive, while consumer spending slows down. The combination of higher costs and a reduction in sales results in lower revenue, so the company becomes less profitable. From a valuations perspective, investors value a company by using a discount rate to calculate the present value of its future cash flow, also referred to as the Discounted Cash Flow method. When applying this valuation methodology, increases to the interest rate result in a higher discount rate, which essentially reduces the present value of that company's future earnings, and consequently, the price that investors are willing to pay for that stock.

Bonds and other fixed-income instruments follow a similar valuation approach. When investors determine the present value of a fixed-income instrument in terms of its future coupon payments, they also apply a discount rate. Similar to equities, higher interest rates have an inverse relationship when determining the present value of future income payments, thereby lowering the valuation of that bond or other fixed-income instrument. In addition, newly issued bonds entering the market will typically offer investors a higher coupon rate, in so doing making previously issued bonds with lower coupon rates less attractive.

Inflation-linked bonds are usually more sought-after by investors in a rising inflation and interest rate environment, as they offer built-in protection against inflation. Their coupons are adjusted higher or lower on a regular basis over time, based on the changing inflation rate.

It's important to remember that markets are forward-looking and that expected changes to the economy and financial markets are already taken into account well before an actual interest rate hike or cut when assessing the prices of assets. Markets typically only have extremely adverse reactions to large-scale unexpected events or shocks, such as the Global Financial Crisis in 2008, or more recently, the partial closing of the economy due to the Covid-19 pandemic. While it's very difficult to plan for such events, at M&G Investments we strive to build well-diversified portfolios for our clients that account for a wide range of outcomes and that are resilient against broad changes to the economic landscape, thereby reducing downside risk while diversifying the potential for returns.

"...cash has historically been the lowest-performing asset class over the long term..."

In conclusion, despite the SARB raising the repo rate by 0.25%, interest rates are still exceptionally low relative to their history, which makes it a good time to reduce your high-interest loans as far as possible. The returns from cash investments may become appealing if interest rates continue to rise, but we would urge against going this route given that cash has historically been the lowest-performing asset class over the long term, with the lowest potential for long-term outperformance.

If you are looking to add to your portfolio, a better option would be to look out for investment opportunities that are trading at discounted valuation levels and that have significantly better long-term growth potential, such as a good equity fund. Another sound option would be to simply add to your existing portfolio and allow your chosen fund manager to adjust the asset allocation within your portfolio based on their assessment of future returns. One of the benefits of going this route is that if you are invested with a fund manager such as M&G Investments, which has a long-standing track record and the backing of a global investment brand, you'll gain access to a broad range of investment opportunities both locally and offshore, thereby reducing risk while enhancing your investment return potential.

Pieter joined M&G Investments in 2015 as Managing Director of M&G Investments Unit Trusts and Head of Retail Business. In 2019 he was appointed as Chief Client & Distribution Officer. With 23 years of industry experience, Pieter previously worked for one of the country's largest financial services groups in a range of senior management positions. He holds a B.Comm (Maths) degree from Stellenbosch University, and is a Fellow of the Institute of Actuaries (UK) and the Actuarial Society of South Africa. He completed the General Management Program at Harvard Business School in 2010 and during 2020 completed a course in Behavioral Finance from Duke University.

Analysis

Eric Lonergan
Multi-asset and Macro Portfolio Manager at M&G Investments (UK)

Global investing: Cash and diversified equities preferable

Key take-aways

- Today's much higher global market volatility in both equities and bonds, and the unpredictability of national policies and market moves, means that investor portfolios should be extra well-diversified.
- Currently M&G is holding more global cash than usual, to take advantage of alpha opportunities amid the volatility. They are neutral in global equities, which are generally trading around fair value (but selective opportunities are numerous) , and are avoiding expensive global bonds.

While there are still attractive investment opportunities in global markets these days, careful diversification and more active management and intervention are needed to get the best results in an offshore portfolio, due to the relatively expensive valuations and higher volatility now prevailing. For global portfolios, at M&G Investments we currently prefer cash and diversified global equities in our asset allocation, while developed market bonds remain expensive across most maturities and investors are paying up (or even losing money) for their diversification and duration benefits.

Is higher inflation here to stay?

To address where we stand in the current debate around "transitory" versus longer-lasting higher inflation around the world, we believe that investors can't conclude that higher inflation will necessarily become a more permanent feature of national economies, and result in much higher interest rates and future stagflation as some are forecasting. The Covid pandemic saw unprecedented and unplanned shutdowns across national services sectors and manufacturing. Producers postponed investment in expanding their capacity, and instead cut costs. Supply chains have consequently had difficulties gearing back up to meet consumer demand, which has accelerated amid the re-opening of economies, in turn causing supply bottlenecks and rising prices. The extremes of the economic downturn, and its following rapid rebound, mean that we can't predict when supply and demand will re-balance across different sectors. Pricing mechanisms still need to fully adjust. So in our view, it's premature to say whether or not we have an inflation problem.

> "...the global rate hiking cycle has begun, with several developed countries having started raising interest rates..."

Equally, predictions of longer-lasting higher inflation ignore the fact that global growth is being driven by several structural engines, namely the recoveries in three main regions: the US, Europe and China. All of these are proceeding at different speeds, and it is impossible to determine how their combination will impact the overall rates of global growth and inflation over the nearer-term. The US recovery has been steady, with bouts of financial market instability, while the EU has registered permanently weak growth, combined with periodic financial stress coming from the peripheral economies (like Greece and Italy) in the absence of central bank support. Finally, China's economic cycle is much further advanced, having already fully recovered from the Covid downturn and now slowing in response to policy tightening.

We can't know how these dynamics will play out, so we believe it's best not to be wedded to an inflation view. After all, having a view on inflation in recent times, whether positioned long or short in developed market bonds, hasn't helped portfolio managers add to returns given the historically low bond yields.

However, it is true that the global rate hiking cycle has begun, with several developed countries having started raising interest rates – but notably some are in response to factors other than inflationary pressures. This includes Scandinavia, where central banks recognized that interest rate levels were abnormally low historically, and the Czech Republic, where rate hikes have been motivated by the economy's particularly rapid recovery. We are certainly not opposed to higher rates from a structural perspective, given the negative real rates that have prevailed.

Positioned for alpha with cash, equities

Using current asset valuations as the foundation for M&G Investments' global asset class positioning, current market conditions mean that we favour cash as well as equities (as the best source of returns), the latter well diversified and not concentrated in any particular sector or geography. Developed market bonds are expensive and generally to be avoided, only being useful for diversification purposes.

In bonds, shorter-dated developed market bonds are still very unattractive – among the most expensive assets to hold – while longer-dated bonds have become more expensive over the past year as government yield curves have flattened. Therefore, to get the benefits of portfolio diversification through bond holdings, investors have to pay up. However, at M&G we have identified more attractive opportunities elsewhere: in emerging market government bonds such as Chile, for example, that should add value to portfolios over the medium term. At the same time, episodes of bond market volatility and mis-pricing have increased significantly, especially since the onset of the Covid pandemic, making it advantageous to adopt a more active (or interventionist) tactical asset management approach to get added alpha from the asset class. This means we have been taking advantage of mis-pricing more frequently, buying and selling assets more quickly to add alpha to client portfolios. Having cash on hand for flexibility in TAA is important in executing this strategy.

As for global equities, M&G Investments considers the MSCI All Country World Index (ACWI) to be reasonably priced from a historical perspective. With valuations trading around fair value, our portfolios are positioned broadly neutrally from an asset allocation perspective. Within the asset class, however, investors need to be well diversified and selective in their equity exposure, holding more, but smaller, positions in order to limit downside risk. This is due largely to the wider divergence across company earnings, sectors, and national policies, and different growth prospects around the world. It is also as a result of increased equity market volatility.

"M&G Investments believes that being more interventionist, and taking on more and smaller bets...are among the most effective ways to add alpha amid the global recovery..."

While certain global equities are offering excellent return potential compared to bonds and cash, others could represent value traps. For example, when the share prices of Tencent and other Chinese tech companies plunged in response to news of additional Chinese government regulation earlier this year, we believed it was a good opportunity to add to Tencent holdings because of the company's diversification and underlying resilience in its earnings. Yet one has to know when to avoid a stock despite its cheapness as well, and have a very clear idea of what you consider to be fair value for a company.

So in conclusion, we are currently at a very unusual juncture in global financial markets, with the impact of the Covid shutdowns, combined with more nationalist policies, leading to significant divergence across economic growth and asset prices around the world. Episodes of idiosyncratic volatility are also more frequent and severe. This has led us to be especially well diversified in our equity exposure, and to be holding more cash than usual to capitalise on sudden asset price swings. Finally, but just as importantly, global developed bonds are best avoided. M&G Investments believes that being more interventionist, and also taking on more and smaller bets in portfolios, are among the most effective ways to add alpha amid the global recovery from the Covid crisis.

Eric joined M&G Investments in 2006 and is a member of the M&G Macro & Multi Asset Business based in London. He previously worked a Managing Director and Head of Macro Research at JP Morgan Cazenove. His qualifications include a BA in Philosophy, Politics and Economics from Pembroke College, Oxford, and an MSc in economics from the London School of Economics.

Stefan Swanepoel
Equity Analyst

SA Corporate Real Estate: Underrated but improving

Key take-aways

- SAC has been selling non-core assets, strengthening its balance sheet and focusing on fewer types of property holdings during the Coronavirus crisis. We believe that its share price is not fully reflecting these improvements in the quality of the business.
- These improvements, together with the strong sale prices it commanded for its properties and the relatively cheap valuation at which it has been trading, make us confident that the company should be able to deliver above-market returns in the medium term.

Among the numerous equity investment opportunities in the aftermath of the Coronavirus market crash in March-April 2020, one that stood out for us was listed property group SA Corporate Real Estate (SAC). Long underrated by investors, we had been holding a 15% stake in the company across several of our portfolios since 2018. Yet amid the pandemic lockdown conditions, SAC's share price was hit even harder than most other companies', having traded at as much of an 85% discount to its net asset value (NAV) in May 2020. In the ensuing recovery, the counter has more than doubled, delivering strong returns for shareholders, and we believe the company still has the potential to deliver market returns well above-average over the next three to five years, of course with some risk involved. But what has made us confident that this bet will pay off for our clients in the face of considerable doubt by the market?

Active insights

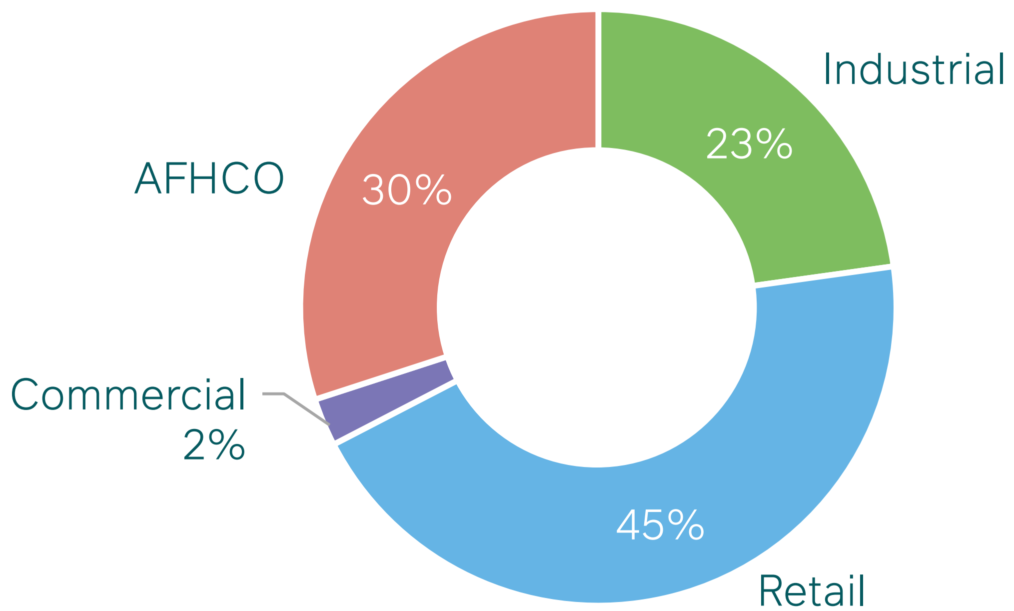
At the time M&G Investments became a shareholder in SAC in 2018, the company was experiencing issues around inadequate governance, one reason for the lack of investor confidence. Because of our large stake and active shareholder approach, we were able to step in and appoint several new Board members with suitable experience and a shared vision, all of which helped steady the business. Our in-depth knowledge as an existing and active shareholder in SAC helped us to eliminate some of the uncertainties around investing in the company and the broader property sector when share prices were near their worst levels.

When diversification is a deterrent

An issue of ongoing concern for investors had been SAC's lack of focus, as a result of its very wide portfolio diversification across every property segment from office, commercial, retail and residential to even include a small percentage of storage facilities. Graph 1 shows how its largest exposure, to the retail market segment, comprises only 45% of its total property portfolio by value. While normally some degree of asset diversification could be considered an advantage, in the listed property sector owning and managing such disparate property types requires more management time and expertise than most SA property companies possess.

Equally, when it comes to investing in property, investors tend to prefer very focussed businesses specialised in just one property segment where management can build their skills accordingly. This allows the investor to allocate their capital carefully across different property segments, depending on the prevailing market

Graph 1: SAC's very diverse property portfolio (by value)



Source: SAC company data

conditions, as one segment will outperform or lag another in different stages of the business cycle.

SAC's ownership of a portfolio of 66 residential properties in the inner city of Johannesburg (including large blocks of flats) was of particular concern due to SA investors' scepticism over their residential business model. This applied notably to their short lease terms of only one year (compared to shopping centre leases of 4-5 years, commercial leases of 2-3 years, and industrial leases of up to 10 years), as well as the specialised residential letting expertise required to manage them efficiently.

This portfolio stemmed from the company's 2014 acquisition of the AFHCO Group, a business that invests in, develops, and manages affordable housing and commercial property in Johannesburg. Although accounting for 30% of SAC's total portfolio by value, its business has not been well understood by the market, along with an existing perception that its large number of properties and tenants consumed a disproportionate amount of staff time and attention. Sourcing new individual residents, verifying their creditworthiness and collecting rents are all very different skills than managing commercial shopping mall tenants and ensuring they are trading at the correct sales densities. These inner-city properties are also partially reliant on migrant workers as tenants, a group that was particularly hurt by the pandemic.

Another factor weighing on the value of SAC's portfolio had been that quite a few of the leases for its industrial properties were coming to an end, with expectations that renewals would come in at lower levels (called negative reversions).

Going smaller but stronger

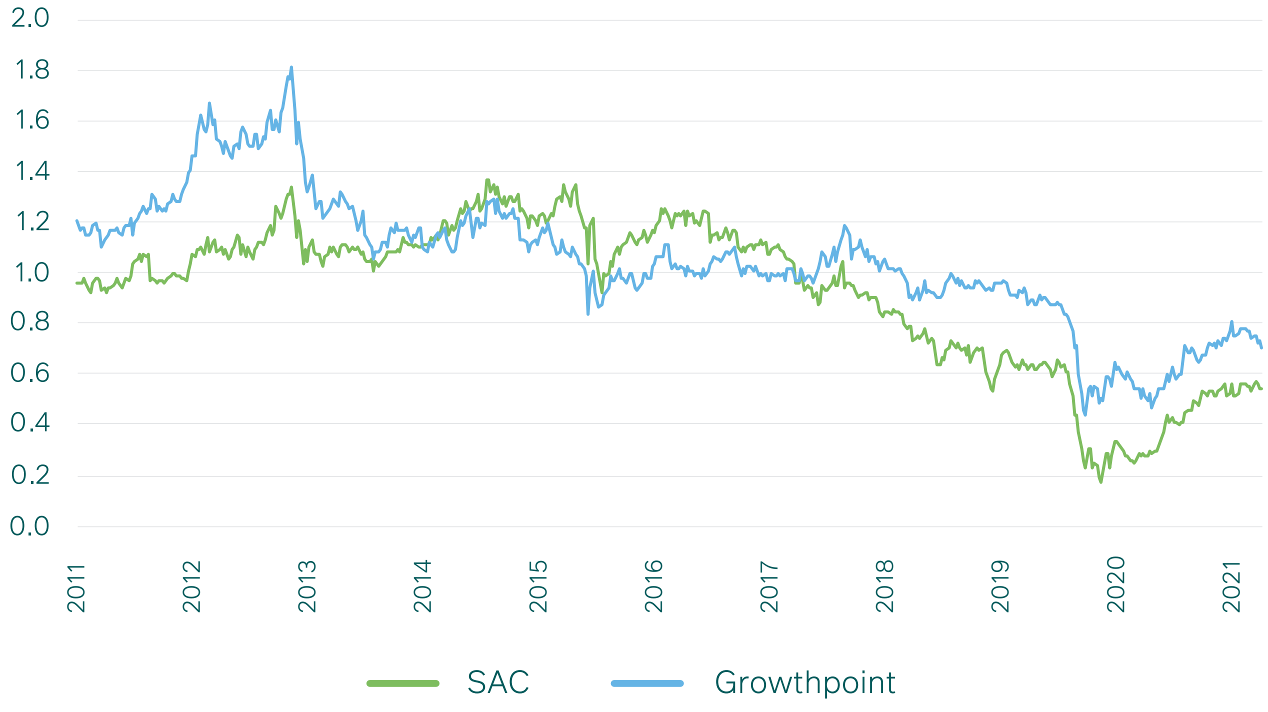
Since 2018, M&G Investments, along with other shareholders, had been urging SAC management to dispose of their non-core assets across various segments and use the proceeds to pay down debt. This became one of the company's top priorities over the past three years, a plan that was accelerated by the Coronavirus crisis. It set about selling some of its office space (the weakest property segment during the pandemic), converting some offices into storage space (the strongest property segment during the pandemic), and breaking up some of its larger offices into smaller, more affordable offices that have been easier to lease. It also disposed of some of its non-core retail properties in outlying areas, as well as some industrial concerns.

To date, SAC has sold over 10% of its property portfolio, accumulating proceeds of around R1.8 billion which allowed it to strengthen its balance sheet. They were far more successful than expected given the depressed economic conditions in which the disposals took place, proving able to command prices at an average discount of only 2% to the properties' book values.

And this came when SAC's overall company valuation (as measured by its share price/NAV ratio) was still at a deep discount.

Graph 2: SAC vs Growthpoint*

Share price/Net asset value



* <1.0X indicates discount to NAV

Source: M&G Investments

As Graph 2 shows, it was trading between an 46%-85% discount as the listed property market gradually recovered from the worst effects of the Coronavirus lockdowns, compared to a bellwether company like Growthpoint's discount of between 30%-57% since March 2020. M&G Investments bought SAC shares for the M&G Equity Fund at around a 75% discount, in the knowledge that the company's balance sheet strength was improving, its portfolio was being simplified while retaining the best assets (thereby improving its overall portfolio quality), and that company management was aligned behind further improvements.

Other positive considerations for our analysts and portfolio managers regarding SAC's investability included:

1) SAC has less office exposure than the average listed property company, the segment worst hit by the pandemic.
2) It owns a strong selection of industrial properties in very well-located nodes. For example, it owns and runs a state-of-the-art facility in Johannesburg for specialised, high-quality tenants like Imperial.
3) Its retail portfolio has a distinct bias towards smaller neighbourhood convenience centres, which benefitted from consumer spending during the pandemic compared to larger, regional or super-regional shopping malls.
4) It has a robust loan-to-value (LTV) ratio at 38%, lower than the sector average, due to its portfolio structure of smaller assets combined with a larger pool of unencumbered assets. This allows management to be flexible with their financing options.

Taken together, all these factors reduced the risk of investing in SAC, and the substantial discount at which the shares were purchased gave us a large margin of error as investors. Since buying the shares, the share price has doubled, producing above-market returns for clients of the M&G Equity Fund.

SAC in the July riots

Properties owned by SAC were among the hardest hit by the riots in KwaZulu Natal and Johannesburg: one of its prime developments, the popular Springfield Value Mart outlet mall in KZN, featured at the centre of the damage and looting. Total damages, including loss of income, were estimated at approximately R560 million, with R557 million relating to its retail shopping centres in KwaZulu-Natal, R700,000 to its industrial properties and R75,000 to its inner-city properties in Johannesburg.

Luckily SAC was covered by SASRIA for the full R560 million of losses of both property and income (not true for all SA companies), representing 3.1% of its total assets. In fact, at the time of writing, trading had resumed at all of the company's other retail shopping centres where the damage was relatively minor. And the remaining restoration was expected to have been completed by October. For Springfield in particular, it will soon receive a more extensive upgrade than previously planned, to higher standards, with no problems foreseen for the reintroduction of its larger retail tenants due to its popular location. SAC will even be saving money on its planned capital spending for the centre. It expects to complete the rebuilding project by October 2022.

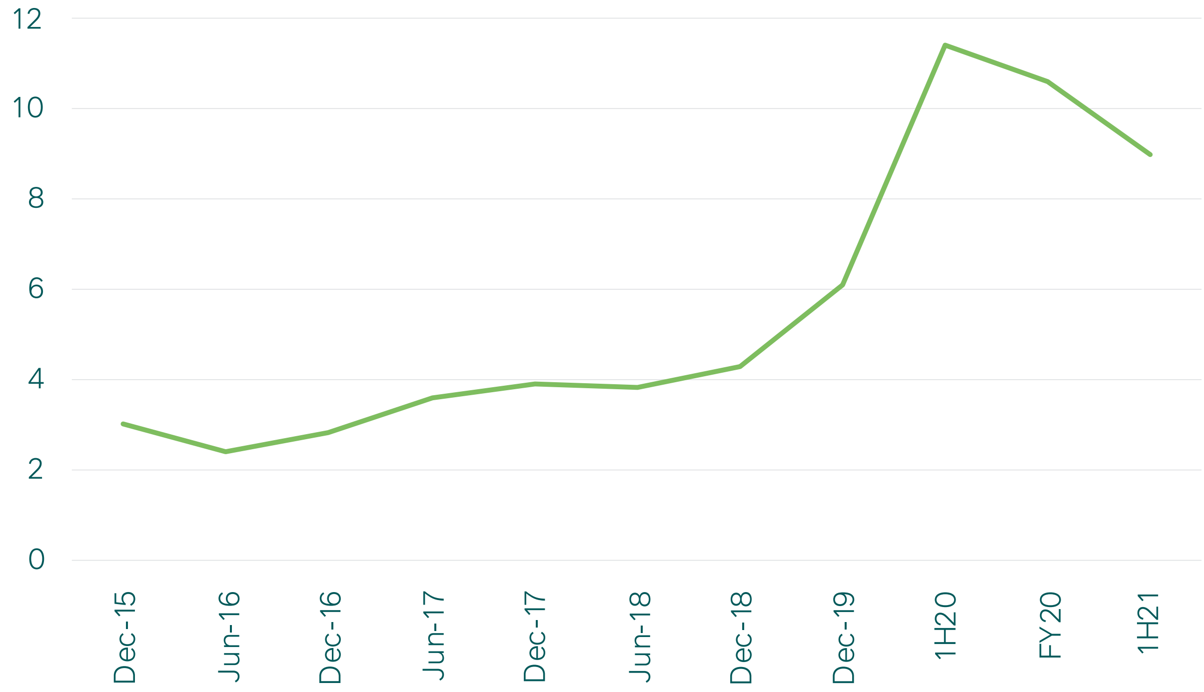
What are the prospects for SAC amid a subdued economy?

Over the near-term, SAC's plans include selling its remaining commercial and non-core residential assets, slimming down further to focus on its industrial, retail and some remaining residential properties. Management has also stated its intention to pay down more debt, consequently reducing the company's interest payments and further improving its LTV ratio and balance sheet. And importantly for investors, SAC is committed to paying out 75% of its taxable earnings as shareholder distributions, in line with its regulatory requirements as a Real Estate Investment Trust (REIT).

In our view, with the industrial property market segment able to command very long-term leases, SAC should be able to improve its returns going forward. However, investors continue to be concerned about ongoing negative reversions for industrial property rentals, which are likely to lead to lower operating income for the group in the near-term, as well as other issues like still-weak retail spending (in absolute terms). This is reflected in the company's share price continuing to trade at a substantial 46% discount to its book value, deeper than that of Growthpoint, for example. This gives SAC the potential to experience a bigger re-rating than its larger counterparts.

Over time and as the local economy continues to recover, we expect the current elevated level of vacancies will normalise across the sector. For SAC in particular it should fall to around 2% of the group's rental income. At the same time, rental collections will improve as landlords no longer have to forgive portions of rents, and tenant arrears, already improving, will continue to do so, as shown in Graph 3.

Graph 3: SAC tenant arrears are falling
(tenant receivables as % of rolling 12-month income)



Source: SAC company data

M&G Investments believes that, given the above factors and developments, SAC has a brighter future ahead for itself and its investors. Like surprisingly many South African companies, it is emerging from the Coronavirus crisis as a stronger entity. It is better managed, more focused and efficient, building greater capacity in its teams and, we feel, headed in the right direction. And as a key attribute for us as valuation-based investment managers, it is still attractively priced, with fewer company and sector risks now than in the past. For us, the market is still pricing excessive risk into SAC's share price, which gives our portfolios, as holders of the stock, greater potential for outperformance going forward through a combination of both capital value growth and re-rating.

Stefan joined M&G Investments in February 2019 as an Equity Analyst focusing on Banking, select Property, Speciality Finance and Insurance companies. With 15 years' experience in financial services, Stefan previously worked at Deutsche Bank Securities and RMB Asset Management. 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.

Eric Lonergan
Multi-asset and Macro Portfolio Manager at M&G Investments (UK)

More active tactical asset allocation paying off

Key take-aways

- Global trends are making market volatility more extreme and more frequent, including diverging national policies, increasing trading automation, more quantitative and high-frequency trading, and increasingly unpredictable government moves, among others.
- These conditions give M&G Investments more opportunities to exploit mis-priced assets and add alpha to client portfolios, leading us to become even more active in our tactical asset allocation approach.

For those who may not know, tactical asset allocation (TAA) is a process in which an investment manager aims to generate additional alpha in a portfolio by taking advantage of shorter-term mis-pricing in an asset class or classes. They buy more of an asset class for a portfolio when they deem its valuation to be cheap, or sell some of their holdings when it becomes expensive – and this can be on either an absolute basis (if it is assessed to be trading below or above its long-term fair value) or relative to other asset classes. They then readjust this allocation back to nearer its longer-term (strategic) level once the asset valuation moves back closer to its fair value. In this way they add shorter-term returns to the overall portfolio, rather than simply buying and holding assets in fixed weights over time.

At M&G Investments we have employed this approach to add value to client returns for several decades now, and were one of its pioneers in Southern Africa, particularly in our institutional client portfolios. What is different now is that in the past few years, particularly during the Covid market crash and ensuing recovery, we have found that TAA has become an increasingly important tool in our investment toolkit.

Why is this? From a macro perspective, we have found more frequent opportunities to use TAA, and been employing it over shorter periods of time. Our increasingly active approach has been due to the rise in the number of episodes of market volatility globally, and the higher degree and shorter timeframes of asset price movements themselves. This is a trend that has been developing globally, in which equity and bond market moves have become less correlated among countries, resulting partly from a rise in idiosyncratic behaviours by individual nations.

National policies diverge

We have seen a move away from the broad global adoption of neo-liberal policies of the 1990s-2000s toward spreading neo-nationalistic policies reflected in the politics of Donald Trump, strong anti-immigration, anti-trade views, etc., and this in turn has resulted in more unpredictable, idiosyncratic and less correlated market movements. Individual country risks are becoming notably more material in our analysis.

Examples of this are numerous, especially in foreign exchange markets, and include: the sudden depreciation and general volatility of the Mexican peso triggered by Trump's rhetoric around the border wall and the North American Free Trade Agreement; the UK pound around Brexit; short-lived crashes in emerging market bonds; China's latest regulation efforts which caused plunges in the share prices of Chinese tech stocks; etc. Investors like ourselves have been able to take advantage of these short-term aberrations in valuations to buy into a security at a cheap valuation, either to hold onto it to take advantage of its capital growth prospects, or to sell it in the shorter-term for a "quick" addition to portfolio alpha.

Changing market structures and technologies

Equally, the structural features of today's financial markets are creating more inefficiencies that we are able to exploit in our TAA approach, making us increasingly interventionist. The higher prevalence of automated and high-frequency trading, quantitative strategies and risk management practices, among others, can create "flash crashes", extreme momentum and other mispricing opportunities. These events can lead us to buy or sell more quickly than before, as well as re-assessing our new positions more frequently,

The upside to volatility and divergence

On the surface it may appear that the higher frequency and degree of market volatility is purely negative for investors, creating more "bad news" headlines, uncertainty and confusion, as well as less predictability. However, for valuation-based investors like M&G Investments, the trend has upside in that it gives us more chances to create value for our clients, while also improving the benefits of diversification in a world where many markets can be driven by the same factors and the same sentiment. These days there is a wider spread between emerging market bond yields as increasingly different sovereign risks are being priced into them, for example, and we can bring our investment expertise to bear on determining which are the most attractively valued given the risks involved.

So amid the current trends of diverging national political and economic models, more complexity and unpredictability, and higher market volatility, a more active asset allocation approach is proving increasingly beneficial for adding alpha to client portfolios. Hand in hand with this comes the need for more careful investment analysis, to ensure we avoid value traps and identify the correct levels at which to buy and sell securities. In such an environment, a global valuation-based investment manager with a successful long-term track record in active TAA, plus a wealth of management expertise and deep resources, is best-positioned to help clients achieve their investment goals.

Eric joined M&G Investments in 2006 and is a member of the M&G Macro & Multi Asset Business based in London. He previously worked a Managing Director and Head of Macro Research at JP Morgan Cazenove. His qualifications include a BA in Philosophy, Politics and Economics from Pembroke College, Oxford, and an MSc in economics from the London School of Economics.

Analysis

Bulent Badsha
Fixed Income Analyst

Fixed income opportunities in a changing interest rate environment

Key take-aways

- Before the Coronavirus crisis, SARB Governor Lesetja Kganyago moved away from the very easy monetary policies of his predecessor to help bring down inflation and inflation expectations, but subsequently had to implement negative real interest rates to revive the economy.
- Cash investments have been delivering below-inflation returns, and it has been best for most investors to avoid them.
- In the rising inflation and interest rate conditions now prevailing, fixed-income investors should consider carefully before moving away from bonds and into cash, as the former still offer much higher real return prospects.

Inflation is the enemy of the fixed income investor. Thankfully, the constitutional mandate of the South African Reserve Bank (SARB) is to achieve price stability. They do this by conducting monetary policy independently and setting the appropriate level of short-term interest rates. The Coronavirus crisis ushered in record low levels of interest rates, leaving cash investors earning very little – in many cases not enough to even beat inflation. Yet despite easy monetary policy, there have been, and still are, opportunities in the fixed income space that investors can take advantage of. So just what do we at M&G Investments believe are these opportunities, and what will change as interest rates rise?

About the SARB

The SARB is a creature of statute, subject to the SARB Act 90 of 1989. Its primary mandate, as explained in South Africa's Constitution, is to "protect the value of the currency in the interest of balanced and sustainable economic growth". Central banks conduct monetary policy through the control of the money supply to achieve price stability. To do this effectively, the SARB adopted an inflation targeting monetary policy framework at the turn of the century. The Monetary Policy Committee (MPC) of the SARB has the responsibility to determine the repo rate, the anchor for short-term interest rates in the economy, which it adjusts as necessary to keep Consumer Price Index (CPI) inflation within the target band of 3% to 6%. The target band was set by the National Treasury, with consultation from the Bank, which then has the autonomy to independently determine the appropriate monetary stance.

Unprecedented policy

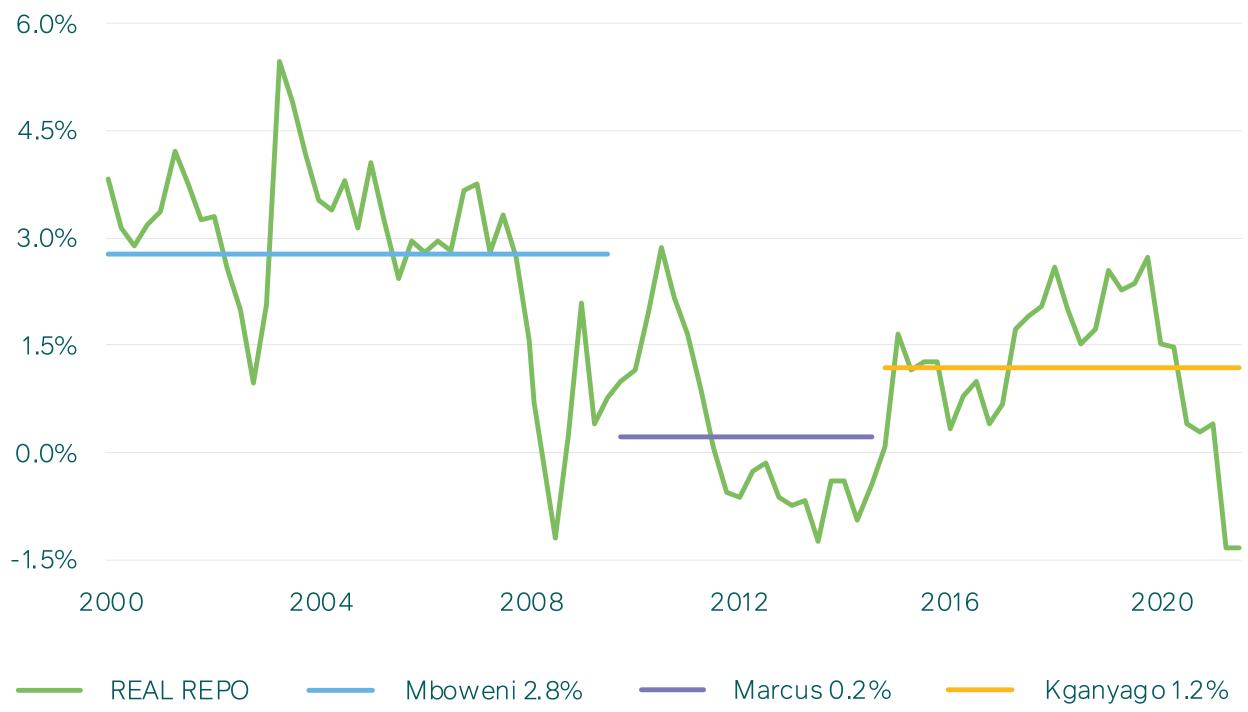
The monetary policy actions taken by the MPC provide the foundation for the term structure of interest rates in South Africa: generally, the longer the term for which the government, entities and individuals borrow, the higher the interest rate paid. These different borrowing rates at different periods help to form the the South African yield curve. Furthermore, the SARB's decisions have consequences for both the level and shape of the yield curve. Interest rate cuts tend to lead to steeper yield curves, while hikes drive flatter curves as the market processes the inflationary consequences of monetary policy actions.

In January 2020, the MPC lowered the repo rate by 25 basis points (bps) to 6.25% against a backdrop of lower realised inflation outcomes and a decline in inflation expectations. This was already a low absolute level in historic terms. Upon the local outbreak of the Covid-19 pandemic, the MPC followed the lead of other central banks by aggressively cutting interest rates by 100bps in March 2020, and again by 100bps in an unscheduled meeting during April. Thereafter, they further adjusted the policy rate lower by 50bps in May and by 25bps in July. These policy actions were unprecedented, with a cumulative 300bps of easing over a six-month period, and the repo rate remained unchanged at a record low level of 3.5% until November 2021. While the MPC cut rates, the yield curve steepened (since shorter-term rates are more sensitive to central bank actions), but more recently it has reversed that trend, flattening amid growing market expectations of coming interest rate hikes.

Getting real

The nominal level of interest rates garners a lot of attention in the news, but any central banker knows that it's the real (or inflation-adjusted) rate that is the true measure of monetary policy. We have viewed monetary policy from this perspective since the adoption of inflation targeting. As Graph 1 shows, the real repo rate (nominal repo rate less the targeted inflation rate) averaged +2.8% under the leadership of Governor Tito Mboweni. During Governor Gill Marcus's tenure, the real repo rate averaged 0.2% and under the present Governor, Lesteja Kganyago, it has averaged +1.2% so far. Its most recent level was -1.5% in October, after having hit all-time record lows earlier this year.

Graph 1: Real repo rate under inflation targeting



Source: Iress, Bloomberg, Stats SA

Given how crucial interest rates are for investors, understanding some of the history behind how they've come to be where they are now is important. As clearly evidenced in Graph 1, three notable developments (or phases of monetary policy) since the February 2000 introduction of inflation targeting have shaped the country's monetary policy. First was the fact that Governor Mboweni, who launched inflation targeting, was consistent from the outset in his maintenance of positive real interest rates to drive down inflation expectations. He succeeded in garnering credibility for the SARB and its inflation-fighting credentials in the face of both the 2001 currency crisis and the 2008 Global Financial Crisis (GFC).

However, in the aftermath of the GFC, that approach to monetary policy was deemed to be too strict, especially considering the dramatic shift in the domestic political environment, where growth was set as the overriding priority. Stemming from this, the second development in February 2010 saw then-Minister of Finance Pravin Gordhan sending a letter to the new Governor of the SARB, Gill Marcus, titled “Clarification of the Reserve Bank’s Mandate”. The gist of this message: to relax the Bank’s stance from being a strict inflation-targeting central bank and adopt a more flexible approach. This allowed for negative real interest rates and resulted in inflation and inflation expectations becoming unanchored from the 3%-6% target over the next few years.

Then in October 2015, Governor Lesetja Kganyago delivered a remarkable and sobering speech in Cape Town at a Bureau for Economic Research (BER) conference entitled “South Africa’s growth performance and monetary policy”, where he admitted that the adoption of a flexible inflation targeting approach came with a huge cost in the form of higher inflation and inflation expectations. As Governor, he embarked on a journey to re-establish the SARB’s credibility and inflation-fighting credentials, with a focus on driving inflation and inflation expectations towards 4.5%, the midpoint of the inflation target range. He did this by raising the level of real interest rates and maintaining positive real interest rates through the worst of the pandemic conditions, until March 2021.

“Cash-type investments also offered somewhat higher returns for investors.”

The investment consequences of this policy shift? During this period rising real policy rates and lower inflation expectations among investors were very supportive of nominal bonds, helping lower the risk associated with them. Cash-type investments also offered somewhat higher returns for investors. By contrast, inflation-linked bonds (ILBs), with their inherent inflation protection, underperformed both cash and nominal bonds.

Investment implications: Avoiding cash under Covid

Exceptionally low interest rates like those prevailing since the onset of the pandemic are a boon for the indebted but a tax for savers, especially those drawing an income from life savings. A wise man once told me that a central bank Governor will know whether monetary policy is right or not based on how skewed the two trays containing letters from the public complaining about 1) how high and 2) how low interest rates are. I would guess it would currently be very lopsided towards the latter.

> "...bond investors extending their investment terms can earn a higher-than-usual yield for the usual amount of accompanying risk"

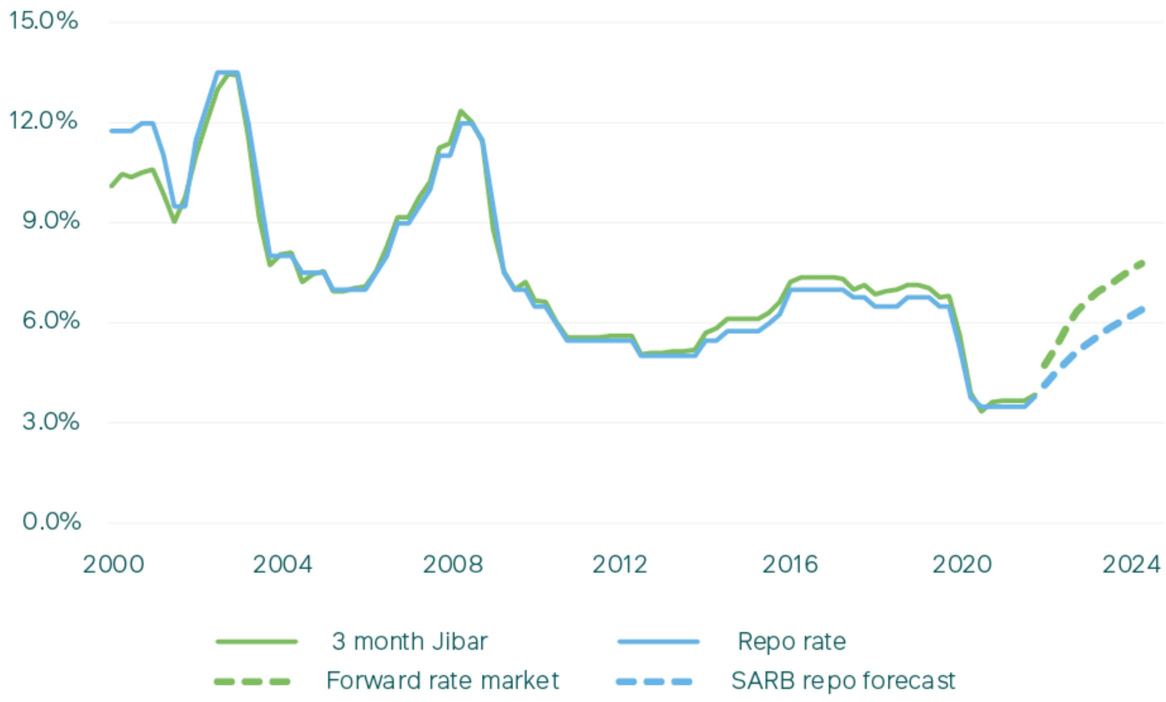
In a reversal of fortunes from pre-pandemic conditions, negative real interest rates have made cash a very unattractive investment proposition. Contrary to conventional wisdom, during this period it has been more risky to hold cash in a portfolio due to its inability to deliver above-inflation returns. Over the past 12 months to the end of October it has returned only 3.8% (as measured by the STeFI

Index). This is why in managing our multi-asset portfolios we have been holding exceptionally low levels of local cash. Fortunately, as investors in search of positive real yields we have found better investment opportunities for our clients in longer-dated fixed-income assets such as nominal bonds and inflation-linked bonds (ILBs), further along the term structure.

Real yields in the nominal bond and ILB markets have been trading above their historic levels in both absolute and relative terms, and both have featured strongly upward sloping yield curves, offering attractive opportunities for the risk involved, in our view. The steeper slope has meant that bond investors extending their investment terms can earn a higher-than-usual yield for the usual amount of accompanying risk.

Our investor portfolios have benefitted from our preference for these assets, with nominal bonds delivering 10.9% and ILBs returning 11.0% over the 12 months to end-October (as measured by the IGOV and All Bond Indices), both significantly higher than cash. Nominal 10-year bonds are currently discounting inflation of 6.2% p.a. on average over the next decade. We believe this is overly pessimistic, in that it assumes that the SARB will not be able to meet its 3%-6% inflation target despite its historic success. For us, the current yields make a compelling investment case for nominal bonds going forward. Meanwhile, we have already taken significant profits in our ILB holdings following their strong performance (absolutely and relative to nominal bonds) earlier this year, and currently prefer nominal bonds to ILBs in our multi-asset portfolios.

Graph 2: Repo rate hiking expectations



Source: Iress, Bloomberg, SARB

Monetary policy normalisation and investment prospects

It is now over 18 months since the Covid outbreak reached our shores, and the financial crisis is largely behind us. Along with other investors, and the SARB itself, we expect monetary policy to continue to normalise now that the SARB has initiated a new hiking cycle with a 25bp repo rate increase in November. As Graph 2 highlights, the SARB's most recent forecast projects further increases totaling 229bps over the next two years, taking the repo rate to approximately 6.0% by the end of 2023. At the same time, the Forward Rate Agreement (FRA) market is currently pricing in the repo rate reaching 7.3% by the end of 2023.

If either of these projections materialise and inflation remains anchored near the midpoint of the target range, that would improve the prospects for holding more cash as an investment again in our portfolios. However, in our view both SA nominal bonds and ILBs currently offer the prospect of much more attractive returns. While a shift towards cash may be appropriate for more conservative investors or those with shorter-term investment objectives, others with longer-term goals should think twice before being tempted back into cash just yet.

Bulent joined M&G Investments in June 2021 as a Fixed Income Analyst and is currently involved in portfolio construction, dealing and research. With 20 years of industry experience, Bulent started his career as a Deputy Economist at the South African Reserve Bank in 2001, before working in a range of Fixed Income and Economist roles at several of the county's leading asset managers. His qualifications include: BCom (Economics), University of Natal.

Analysis

Jim Leaviss
CIO of Public Fixed Income at M&G Investments (UK)

Watch out if the USA defaults – it won’t be pretty

Key take-aways

- US Treasury bond yields act as the foundation or risk-free rate of the global economy, so it could cause global market chaos should the US Treasury be unable to meet their repayments on time.
- Although it's not likely that US debt would have to be rescheduled or that investors would actually lose money, a technical default or the inability of Congress to raise the debt ceiling could spark a downgrade of the US sovereign credit rating, as occurred in 2011.

The most powerful nation in the world, the USA, stands on the brink of a self-inflected debt default, an event that the US Treasury Secretary Janet Yellen says would cause recession and a stock market plunge, and which the credit rating agency Moody's says would cause Americans to "pay for this default for generations". We know how we got here – the polarisation of American politics and the toxicity the Trump years which has led to some 70% of Republicans not accepting Biden's Presidency as legitimate.

But this isn't entirely new, and President Obama faced a similar crisis in 2011 when the Republican Party also refused to increase the debt ceiling. The debt ceiling is a measure which was originally intended to prevent a President from increasing spending to fight foreign wars, but which today has become a political tool used to try to ruin Joe Biden's fiscal stimulus plans, make him look weak, and pave the way for the GOP to regain control of Congress in next year's important mid-term elections, leaving Biden as a lame duck for the remainder of his term. Treasury Bills maturing around the time of the possible default (likely to be December this year if nothing else happens) have started to wobble, and US Credit Default Swaps (a measure of the cost of insuring Treasury bonds against default) have increased, albeit to still-low levels.

Looking back at the 2011 debt ceiling crisis, it did lead to the US government's sovereign credit rating being downgraded by S&P, from AAA to AA+, which was a huge deal at the time. S&P said that it expected the US's fiscal position to deteriorate over coming years, and it did, by more than they predicted. Net General Government Debt hit 80.7% of GDP in 2015, and 103% of GDP in 2021 (Covid spending of course was partly responsible for the most recent increase), all way above what was traditionally seen as "safe" for a AAA rated economy (around 60% or below). S&P also then worried greatly that the absence of bipartisan consensus on fiscal policy put America's credit rating on a weak footing – fears that must surely be higher now. Should we expect to see further US credit rating cuts?

> "Expect a missed coupon payment to cause chaos in global financial markets"

Well yes, and especially if the US does default on an interest payment, even if that default is more technical in nature rather than a formal debt restructuring resulting in losses for investors. US Treasury bonds are the foundation assets of the global economy – all other sovereign bonds are compared to them. Their yields set the "risk free" rate for the global economy, and from that we value equities, real estate and everything else. So expect a missed coupon payment to cause chaos in global financial markets.

There is little likelihood that investors (including China and Japan, each with over $1 trillion of Treasuries) will take a haircut (or losses) on this debt. Why would a sovereign nation with the ability to print its own currency, ever need to restructure its debt? And that for me is a problem with the credit rating agencies – when looking at the US, the real risk for investors is normally around inflation. A government could inflate away its liabilities (10% inflation would halve the "real" debt burden over seven years), and yet because investors get their $100 back when the bond matures, the rating agencies are happy. The AA+ credit rating only tells you that S&P expects you'll get $100 paid to you, not that you'll be able to buy the same amount of goods with it as you used to. And this seems like a failing of the methodology. In the meantime, watch out below as the US's reputation for fiscal and political competence takes a hit - global markets and economies won't like that.

*This article was sourced from M&G Investments (UK). Read more here.

Jim joined M&G Investments (UK) in 1997 and in 2020 was appointed as the Chief Investment Officer of M&G Public Fixed Income. He is responsible for managing and co-managing a range of fixed income funds domiciled in London and Luxembourg; and heads the team responsible for investing across investment-grade and high-yield credit, government debt and emerging markets debt. With nearly three decades of investment management experience, Jim started his career in the investment industry at the Bank of England in 1992 where he worked as a gilt market analyst and dealer. His qualifications include a B.A. (Econ) Economics from the University of Manchester and completion of the Executive Programme at Singularity University, Silicon Valley. He is also an Associate of the CFA Society (UK).

Analysis

Anthony Walker
ESG Specialist

Shifting ground, coal and finances... And a little ray of sunshine

Key take-aways

- We have seen some tangible, positive changes in South Africa recently, amounting to progress in our transition away from coal. These have come in the form of fresh global financing, new government policies on renewable energy and new company-specific plans. Both the public and private sectors have key roles to play in meeting the COP26 environmental targets.
- As active shareholders representing our clients, we also have an important role to play by engaging directly and helping guide companies through the complexities of this transition, while also ensuring we understand the complexities and clearly communicate the impact on investment returns.

While queuing for local elections, and its domination of the news recently, South Africans probably missed out on something happening just over 10,000 km a way. And although not as instantly dramatic as our transition to a free democratic nation, it carried a few of the same hallmarks – big promises, big transitions, uncertainty, and a difficult journey to not only save us, but future generations. Hope, mixed with some scepticism.

South Africa is one of the key nations that sits close to the spear tip of “Just Transition”. We have a real and urgent need to shift away from coal, but being an emerging market, the costs and social implications are a tricky road to tread. Currently, South Africa’s energy supply is 92% dependent on coal. Our energy supplier, Eskom, is listed in the Climate 100+ report as a target for reduction. But the costs and project timelines for moving away from coal are quite staggering, and even Eskom's ageing coal units are problematic. We live with this reality daily, so we can skip the background – no doubt a two-hour practical reminder will be in our areas shortly.

Although this experience has been bleak, in recent months the ground started to shift, and we have seen some tangible change. There is certainly more work to be done – more on that later – but there has been some credible movement that follows a lot of mere talk in prior years...and some surprises from the private sector space, all of which add up to signs of sunshine in our transition towards cleaner energy. So what we have seen?

COP26 financing and Eskom

One of the largest pieces of news, largely absent from major South African media, has been the announcement of a USD8.5 billion dollar (R125 billion) 'concessional finance' deal (or offer – the definition is already being debated) from international partners to help South Africa in its transition to greener energy. This is an exciting development arising out of the global climate summit in November (known as COP26), and it appears (although details are still emerging) that aspects could be used to help Eskom directly through non-coal projects. Partners to the climate finance deal include the US, UK, and European nations, and EU organisations.

The terms of this deal will be critical, but it is a very significant step forward. Along with our global parent M&G plc, we engaged Eskom in the past month (at time of writing) on their coal transition, though well before the COP26 announcement. It is clear South Africa cannot escape coal quickly, and there are some complex capital allocation questions and social-community issues that accompany our transition. The realistic outlook and frankness of the Eskom team we spoke to was something we do not always see when engaging a parastatal. While net zero emissions by 2050 is in doubt, what is encouraging is that pilot projects are underway on a small scale, there is a dedicated transition team, and members of this team have the ear of the President. Additionally, practicality appears front of mind, with dedicated specialist teams at Eskom, and some have been in service for a long period looking at these matters. This is no longer about talking – projects and small-scale pilots that can be rolled out on a larger scale are being tested already. Funding could potentially have a meaningful impact for the entity's journey. We – and the country as a whole – are not out of the woods, but a pathway towards meaningful carbon reduction is emerging, and we have international support.

"…projects and small-scale pilots that can be rolled out on a larger scale are being tested…"

Following COP26, there has been an outpouring of concern that not enough has been done; agreed measures have been too weak and timing too delayed, and key players have not turned up with enough sincerity. These concerns will be well founded. However, It is important to recognise that we are seeing a shift, and real change is happening, even if the pace is of concern.

Public sector support

It is widely recognised that Eskom and local private players need government support. So what movement have we seen on this front in recent months? Notably, there have been two key changes: First, the changes to licensing around power generation levels. The new 100MW cap before licensing is very exciting and long awaited. Miners have been crying out to bring in their own power production via solar (also called photovoltaic, PV) or wind power, and we have heard their frustration in our engagements with them. This is not purely for the sake of green power and carbon footprint reduction, but also to remove dependency from the grid. Apparently government has finally heard them, too. Some miners commenced production of their own power before the announcement, in anticipation of it, making some of these projects advanced. It should be noted that new power cannot be easily fed into the grid (called 'wheeling') – this is more complex than one might assume. But on a national level, as our power production and consumption shift, it takes pressure off of Eskom and some of our coal production.

Speaking of national carbon emissions, the second, more radical, change from the public sector this year saw the South African government announce better Nationally Determined Contributions to reduce the target range of national emissions and better align with the Paris goals. It should be noted that this is a non-binding commitment, with intended ranges. The commitment itself, though, is another step forward, and we will be studying it for practicality in time.

The next critical step will be updating the Integrated Resource Plan from 2019 (IRP 2019), and the hope is that this will be revealed shortly, and reflects the current inertia.

Private Sector support

Some of the larger 'surprises' we have seen this year have come from the private sector. We have become accustomed to precious metal miners pursuing green projects, and green energy (albeit in part to reduce grid dependency). Hydrogen-powered trucks are being piloted (quite literally) around some of our platinum mines. Other miners have lagged a bit, but the gold and platinum miners are proactive in projects and engagement. Having engaged them over the years, Exxaro has been pivoting towards greener energy, and mining greener minerals. The company's Capital Markets Day on 20 September showed some concrete evidence of this, tempered with caution around risk management. Exxaro will have coal exposure for many years to come, but we have seen them removing 'dirtier' coal mines and focusing on higher grades, and this is the next step for them. Some caution is required, but their presentation showed structured thought and strategy, and recognition that if the business should continue into the future as an energy or commodity producer, coal will need phasing out. For investors, the longevity of coal being an indefinite resource is no longer in question – exiting now comes down to "how ", rather than "if". . Do they want Exxaro to first work down the coal assets and exit, or pivot to green energy in that process? It becomes an interesting space of measuring risk, costs and opportunity for company management and analysts. "Greenfields territory" starts taking on a new meaning.

Sasol also recently held its Capital Markets Day, unveiling ambitious targets in respect of its vision for moving to net carbon neutral and long term energy sources of feedstock. This was encouraging to see, but in contrast with Exxaro, a bit less concrete, and more 'visionary'. Details were less clear, and some question marks around the base year. To be fair to Sasol, much will depend on acquiring and piping new feedstock. Building pipelines for hundreds of miles is not an overnight process. The company offered some details on PV power generation, but the scale needs interrogation. Its 2030 targets for emission reductions were also revised to much more meaningful levels.

What should investors consider -- and do?

"Hesitant optimism" is possibly the best reaction to all these developments, though more needs to be done. Practically, however, what do all these changes and signals mean for investors, asset managers, the public and the public sector?

For investment managers like M&G Investments, there is a need to recognise that change is not only required, but that practically we are seeing key players in the environmental challenge pivoting away from "greenwashing" (or simple window dressing of their practices), towards constructive planning and implementation. We must equally shift from being concerned about greenwashing to the practical aspects of achieving progressive change. Are the companies' targets reasonable, and are milestones in place to reflect this trajectory? What are the cost implications and opportunities – will their changing earnings impact our client returns? Do the entities have the right teams and expertise in place? In a world of opinions, visions, mission statements – what should this expertise practically look like? Finally, asset managers carry a fiduciary and contractual obligation to generate returns for clients – how should this be balanced against increasingly complex and sometimes conflicting social and environmental responsibilities? How should the latter be valued?

> "Asset managers...need to provide clear reporting and develop stances on complex matters to in turn guide clients in their decision-making process in selecting both managers and products."

In the broader sphere, asset managers need to engage regulators and indexes such as the JSE. We hold key amounts of capital, and we have an obligation to provide guidance. The assets are not our own, however, and clients need to add their voices. Additionally, industry associations can play a role, but there needs to be fewer and more concentrated efforts. There are simply too many projects, delegations, codes, taxonomies, and projects by vested-interest parties for asset managers to be meaningfully involved in.

For clients there is therefore a need to engage practically with asset managers. How will funds' return profiles change if there is screening out of certain companies? Philosophically, do they want to remain invested in companies that are responsibly shifting to better practices, and what will exclusion do – does it send a message and deny capital to offending companies, or simply shift assets to private equity investments where company accountability is impossible for public investors to achieve? There is also a need to engage meaningfully – we often receive client queries requesting carbon reduction (and investment universe reduction), but equally wanting to retain the same portfolio risk and return profile, and keep benchmarks that have high exposures to non-green companies. Asset managers in turn need to provide clear reporting and develop stances on complex matters to in turn guide clients in their decision-making process in selecting both managers and products.

In the public sphere, the commitments, regulations and cost implications (such as carbon taxes) need to be consistent, transparent and clear. Certainty is key for both investors and entities. This is true on all policy levels. Capex will be required for companies to transition, but with endless uncertainty on government policy in so many realms, they might be reluctant to undertake this expenditure domestically. We have one major listed entity exclusively exploring green energy overseas, simply because they view the local regulation too cumbersome, and the matters around land rights and licenses too uncertain. As mentioned above, asset managers can play a role here in supporting entities. Collaboration and collective representation will become key.

In conclusion, we are entering an exciting, changing space, and there is concrete action. We have moved from statements to policy, and this is translating into actual projects. We can breathe just a moment and find optimism. The next steps are complex and tricky, and no one should pretend to have all the answers. But we can celebrate a good week 10,000km away in Scotland, potential international finance, and some government progress. I think we can take a brief look back to see where we have come from. Next week we push forward, our path lit by a little ray of sunshine.

Anthony joined M&G Investments in 2007 as an Institutional Client Manager and in March 2019 was appointed as an Environmental Social Governance (ESG) Specialist. He is primarily responsible for M&G Investments' ESG reporting and related work. Prior to joining M&G Investments, Anthony worked as an attorney and an Employee Benefits consultant. He holds a Bachelor of Commerce degree in Law and a postgraduate LLB degree from Stellenbosch University.

Aadil Omar
Head of Equity Research

Trust the process

Key take-away

- Humans generally face dynamic environments with random and unpredictable outcomes, but prefer certainty and simplification. To reduce this uncertainty and help us make more informed decisions that lead to better outcomes, we can employ processes that have proved successful over time.

In writing for this publication over the last two years, I've had the opportunity to explore, through reading and observation, the concepts of uncertainty, risk and complexity, among others. The theoretical underpinning was prescient given the events that unfolded over the course of last year as the pandemic gripped the world. I can say I've probably got a deeper appreciation of these concepts, but I remain uncomfortable with the lived experience. Thinking about the world probabilistically is not a natural tendency and won't be for the human species for a long time to come. This observation was clear every time some commentator made a confident deterministic prediction about how the pandemic will/won't resolve. Our need for certainty drives a strong urge to reduce uncertainty through simplification. This often leads us down the path of ascribing cause to the intuitive and superficially observable.

I have, however, also observed a few tools used quite effectively to navigate the moments when uncertainty dominates. At the heart of many of these was a systematic process-driven approach. I cannot elaborate much on the specifics of why some strategies work the way they do, but in general, continuing to paddle in the right direction even when the fog hides progress has been the right strategy.

Stable but random vs. Dynamic

> "Everything should be made as simple as possible, but no simpler."
>
> — Albert Einstein

I recognise the tendency to force complex elements into a simple framework. It is the path of least resistance and feels intuitively more comfortable than thinking about things probabilistically. And for many of the less consequential instances in our lives, approaching complexity in this fashion is of little consequence. However, for events we are continually exposed to and that compound on us, the "shoot from the hip" approach is unlikely to be beneficial unless you're very lucky.

To illustrate the point, in Table 1 we draw a distinction between two types of environments – Stable vs. Dynamic. In each environment, we would like to know whether we're able to accurately predict or forecast the outcomes of events using all knowable information.

Table 1: Stable vs. Dynamic Environments

		Type of environment	
		Stable	Dynamic
Outcomes	Forecastable	Q1	Q4
	Random	Q2	Q3

Source: M&G Investments

The table therefore yields four quadrants across two axes:

Q1: Stable and Forecastable
Q2: Stable but Random
Q3: Dynamic and Random
Q4: Dynamic but Forecastable

Events that are perfectly predictable are those influenced by variables that are themselves predictable. Perfectly stable environments are artefacts primarily of human invention and tend to be quite confined. An example of a stable environment would be a roulette wheel or a cooking oven (when used to bake). Dynamic environments, by definition, would not be forecastable. Quadrant 4, the shaded area in the table (Dynamic but Forecastable environments), is therefore technically impossible.

This article is, however, not about getting hung up on technicalities, so we will focus on the practical experience of dealing with dynamic environments. Indeed, when going through our daily lives, we don't have the sense that every moment is completely unpredictable, albeit we live in dynamic environments. We can differentiate those times when things are truly chaotic from the ordinary course when things are more predictable within a range of outcomes.

Getting back to Table 1, we've established that Stable and Forecastable environments (Q1) are rare, but baking a cake would be a reasonable enough example: if you follow a recipe and ensure the environment remains stable, outcomes can be reliably predicted. Stable but Random environments (Q2), also primarily engineered by man, would comprise most casino games like roulette or craps. For any single event, the outcome is random. The range of outcomes in these environments is limited, however, so the truly unexpected event would not feature.

Dynamic environments are pretty much where most other activities live. Some are more forecastable than others. For example, taking a standardised test would fall into Quadrant 4. If the candidate understood the course work and was able to complete the test within the allotted time, we can make a reasonable predication on the outcome. By now dear reader, you should suspect that Dynamic and Random (Q3) are the environments that embed much of the complexity we so desperately want to tame. We'll have a look at a popular game theory example to better understand Quadrant 3.

The prisoner's dilemma

Readers familiar with game theory may recall the infamous thought experiment known as the prisoner's dilemma. The thought experiment is as follows:

Two members of a criminal organization are arrested and imprisoned. Each prisoner is in solitary confinement with no means of communicating with the other. The prosecutors lack sufficient evidence to convict the pair on the principal charge, but they have enough to convict both on a lesser charge. Simultaneously, the prosecutors offer each prisoner a bargain. Each prisoner is given the opportunity either to betray the other by testifying that the other committed the crime, or to cooperate with the other by remaining silent. The possible outcomes are:

If Bonny and Clyde each betray the other, each of them serves two years in prison.

If Bonny betrays Clyde but Clyde remains silent, Bonny will be set free and Clyde will serve three years in prison.

If Bonny remains silent but Clyde betrays Bonny, Bonny will serve three years in prison and Clyde will be set free.

If Bonny and Clyde both remain silent, both of them will serve only one year in prison (on the lesser charge).

The game is often used to highlight the benefit of cooperation, but it also highlights the difficulty of trying to win a game where the outcome is dependent on variables over which you have no control or influence – a dynamic environment. For a single play of the prisoner's dilemma, the perfect solution does not exist, and each player is at the mercy of the other. In such a case, it is not unusual for most players to hedge their bets by betraying the other. It's the logical response to a situation over which control is limited.

Repeated play of the prisoner's dilemma (known as the iterated prisoner's dilemma), however, presents an opportunity to make strategic choices to maximise outcomes. The repeatability introduces a new dimension that lends itself to a testable process. Although the game remains dominated by random outcomes, a logical process can nudge the game in the direction of predictability.

Since the prisoner's dilemma is structured to benefit players through cooperation, the correct strategy is one that evolves toward cooperative behaviour. Greedy strategies tend to do poorly over the long run (if the game is played iteratively) as do overly trusting strategies. Although it does not guarantee a successful long-term outcome, a cooperate then tit for tat strategy (eventually culminating in complete cooperation) proves to be the best option for maximising long-term outcomes. However, it is only the continued play that provides the opportunity to implement a strategy and put a process to work.

Taming the complex

"What is elementary, worldly wisdom? Well, the first rule is that you can't really know anything if you just remember isolated facts and try and bang 'em back. If the facts don't hang together on a latticework of theory, you don't have them in a usable form."

— Charlie Munger

Charlie Munger, the erudite long-standing partner of Warren Buffett, is highly regarded for his wit and insight. He has made no secret of his process for erudition – he simply treats the accumulation of knowledge as an iterated game.

Fortunately, in many endeavours of our lives we get to play an iterated version of the game where a process may well be beneficial. These can range from how to optimise your diet to becoming a better conversationalist. Indeed, even the randomness of casino games is overcome by the casino because they are playing an iterated version of the game with a favourable edge. If casinos played a single version of a casino game, no matter how favourable the edge, the randomness would overwhelm any prospect for consistent profitability. That's why casinos implement a maximum table stake for each game.

Similarly, investment decisions are quintessentially an activity that sits squarely in a dynamic environment, as evidenced by the high degree of variability in investment outcomes. Nevertheless, there is still a significant benefit to be had by following an investment process rooted in phenomena that have stood the test of time. I find this remarkable tool is often underemphasised in investment-related discussion. Most investors will seek investment insight through reading, debate and discussion, hoping to glean some insight and hopefully remember to implement it at the appropriate time. But without a process to hold and make these insights executable, it's unlikely to find its way into your decisions. A similar theme can be observed for diet, exercise and sleep habits.

Closing thoughts

The last two years have certainly been extraordinary by anyone's book, and for most of us the world remains a remarkably unpredictable place. If there's something I have gleaned from the craziness, it is that if you're serious about making progress in dynamic environments, you should have a process. It is not an easy task, nor is adherence likely to be without interruption, but even a simple roadmap to guide the direction of travel and help steer clear of pitfalls is better than shooting from the hip. Designing, implementing and trouble-shooting a worthy process is beyond the scope of this article, but I can report that having a time-tested process is something we hold sacrosanct at M&G Investments. □

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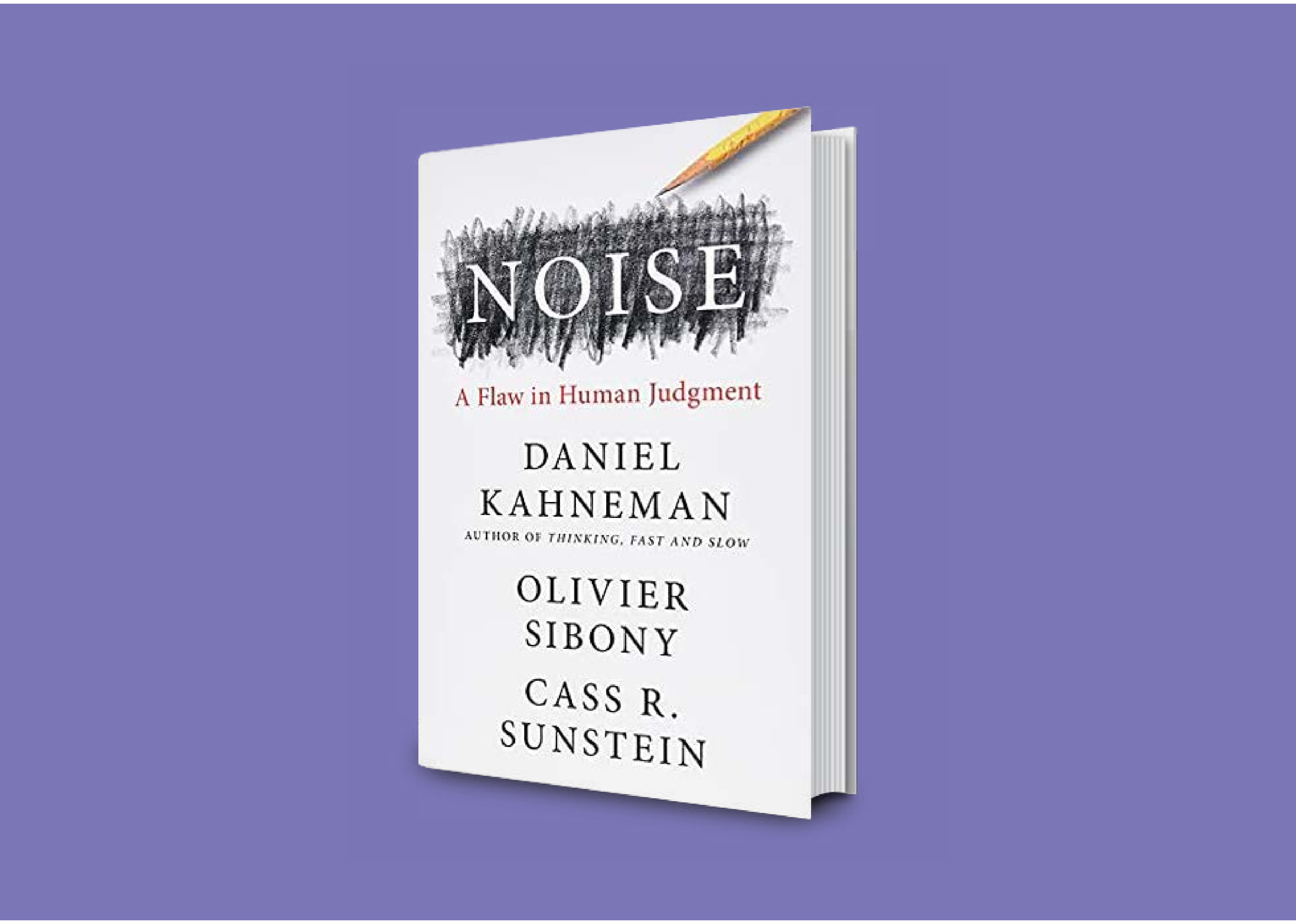
Book Review



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Where's the Noise?

In *Noise: A Flaw in Human Judgement* by Nobel laureate Daniel Kahneman (also the award-winning author of Thinking Fast and Slow), Professor of Strategy and Business Policy at HEC Paris, Oliver Sibony and Cass R. Sunstein, Professor at Harvard Law School, the authors examine the sources and impacts of errors in judgement and look at ways to reduce them.

The authors define judgement as the process, as well as the product, of reaching a conclusion that can be summarized in a word or phrase. According to the authors, an error in judgement contains bias and noise. Examples of judgements can be performance reviews, bail applications and medical diagnoses.

The clearest analogy of bias versus noise I could find was not in this book, but an article from the Harvard Business Review[1]. Consider a bathroom scale that consistently gives a reading that is too high, this is an example of bias. If the scale gives different readings when you step on it twice, the error is caused by noise, much like inconsistency. This is a good article to read if you are considering buying this book.

The book comprises six sections, each consisting of between 3 and 8 chapters.

Section one dives into how the criminal justice system can be noisy. I found the history on Judge Marvin Frankel's crusade to reduce noise in this critical system to be a valuable lesson

[1]*High, Hidden Cost of Inconsistent Decision Making* by Daniel Kahneman, Andrew M. Rosenfield, Linnea Gandhi, and Tom Blaser: (https://hbr.org/2016/10/noise).

regarding the pros and cons of reducing noise. It provided a real-world example of attempts to reduce noise in a complex system, the challenges faced, the impact it has, as well as highlighting issues created by the attempts to reduce noise. It also introduces one to system noise, and the variability in judgements that should ideally be identical.

This is followed by an account of the authors' first encounter with noise, when a consulting firm (where two of the authors worked) was asked by the executives of an insurance company to assess the potential value of increasing consistency in their policy and claims process. The authors labelled the analysis "detecting noise", a noise audit. The result of the noise audit gave rise to a key theme throughout the book: *wherever there is judgment, there is noise – and more of it than you think*.

In section two the authors go into the details of measuring error. They define bias as the mean error (the average error occurring in numerous examples over time). Noise, meanwhile, is the variation around that mean, measured by one standard deviation. They then go about proving that noise and bias are both important components of error, and that total error will be reduced equally by noise or bias, if either is reduced by the same amount. I found large parts of this section tedious and unnecessary. A lot could have been summarised by some formulas in an appendix.

In the introduction, the authors suggest that if you are primarily interested in noise reduction, you should skip sections 3 and 4, and go straight to section 5. Section 3 goes into predictive judgements and explains how algorithms are free of noise and why machine learning is better at predictions than humans, given enough data. Part 4 provides insight on the sources of noise and uses some of the theories developed in Kahneman's *Thinking Fast and Slow*.

In the above-mentioned sections, the authors also decompose error into bias and system noise, where system noise comprises level and pattern noise. Remember, judgement does not necessarily refer to the judiciary term – but it is used to understand the various types of noise in this example. Assume a judge is usually rather lenient in comparison with other judges, except when the defendant is a middle-aged man. Another judge is usually harsh, except when it comes to cases where the defendant is younger than 20. Level noise is the variability in the severity of judgements made by different judges. Pattern noise is how judges differ in which defendants require more severe or more lenient treatment.

Sections 5 and 6, as well as the appendices, are more practical, and I would recommend reading these to anyone looking for guidelines on how to detect noise within processes ranging from policy making to underwriting to judging wine. The reader is also introduced to several techniques to reduce noise, referred to as "decision hygiene".

As investment managers, our team at M&G Investments must make frequent judgements (or decisions) that impact our clients' wealth, making this an important topic for us. One key to successful investing for us is to eliminate as much bias and noise as possible in the investment process, and to be consistent around both level and pattern noise. While all humans make flawed judgements, we mitigate error and variability through employing a team approach and closely following a tried-and-tested process, among other tactics.

I must admit that after reading this book I am much more aware of noise, which I believe is what the authors set out to achieve. I did, however, find the book too long, and the structure sometimes confusing. It was not always clear why some topics were skimmed through, and others explained with tedious detail. I found myself re-reading chapters because I got lost in the detail, and at other times going off and reading Wikipedia pages on academic theories mentioned in the book, for instance Paul Meehl and Lewis Goldberg. Some consistency would have gone a long way in making it a more pleasant and engaging read. There is also not much attention given to the pitfalls that arise from findings like (quoting without context) "Noise is mostly a by-product of our uniqueness". ◻

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