M&G Insights

M&G Investments

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August 2022

SA Bonds offering attractive return prospects

Investors may be surprised to learn that the South African nominal bond market has delivered healthy returns to those prepared to brave the volatility in recent years. Over the past five years our bond market has comfortably outperformed both SA cash and local inflation, as well as global bonds: the FTSE/JSE All Bond Index (ALBI) has returned a surprising 8.0% y/y versus -0.5% y/y from the Bloomberg Global Aggregate Bond Index for the five years to end-July 2022. Consider that during this time investors have had to contend with SA's sovereign credit rating being downgraded to junk status and below, the rising debt levels of the National fiscus, the impact of Covid-19 on "SA Inc", the July 2021 riots, and who could forget load-shedding! Given this backdrop, one could be forgiven for assuming that bonds would have been a poor investment choice, but instead the opposite has been true.

Prospective returns still very attractive

Unlike the healthy longer-term returns, the past year has been more challenging fot the South African bond market. The Russia-Ukraine war, much higher-than-expected global inflation, aggressive interest rate hikes and a slowdown in the global economy have all resulted in greater investor risk aversion, sending both global and local bond yields higher. This sell-off has resulted in a return of only 0.5% from

the ALBI for 2022 so far (to end-July). However, compare this to the appalling -12.1% return from global bonds over the same period – our domestic bonds have consistently outperformed their global counterparts.

What this more recent weakness means is that prospective returns for investors have not deteriorated. With 10-year yields at just over 11% and longer-term inflation expectations still relatively well-contained thanks to the South African Reserve Bank's efforts, investors are looking at a prospective real return which should be above 6% p.a. over the medium term – a very attractive return package, particularly when faced with a cash return which will struggle to beat inflation.

Given the promising outlook for bond returns, we thought it might be useful to reflect on the drivers of bond fund returns and how the local bond market investment opportunity set has evolved over time.

Different levers for sourcing bond fund returns

Broadly speaking, the three primary "levers" an active manager can employ in an attempt to outperform the FTSE/JSE All Bond Index (and generate alpha) would be one or more of the following:

- Holding more corporate credit exposure than the benchmark. As corporate bonds expose investors to a higher risk of default, these bonds pay higher yields than those on similar government bonds as compensation;
- Taking views on the level and future direction of bond yield moves as interest rates change over time. This involves positioning a portfolio to be more or less sensitive to yield moves (commonly referred to a funds 'duration' positioning); and
- Taking positions on the shape of the yield curve (curve positioning), by identifying mis-pricing opportunities in different bonds in absolute terms and relative to each other, and looking for tactical opportunities to concentrate the portfolio in certain parts of the yield curve where analysis shows the best risk-adjusted returns are likely to be generated.

In theory, asset managers will actively use all these levers to generate returns for clients. In practice, however, market conditions, valuations and relative opportunities dictate the extent to which they

employ each lever in their funds, and these have changed over the years.

At the turn of the millennium, the local corporate bond market was still in its infancy, and it was then that investment managers started to take advantage of the first lever to generate excess portfolio returns. Growth in local credit issuance was strong over the next eight years or so, and this became the primary driver of returns for funds like the M&G Bond Fund. However, the 2008 Global Financial Crisis heralded the end of this robust growth, largely due to the much higher levels of compensation investors started to demand for the risk involved. It gradually became too expensive for most corporate borrowers to raise cash via bond issues, instead opting for cheaper bank loans.

In 2015 an investor could buy a fixed rate bond issued by a bank at a yield of 1.9% above the equivalent government bond – an attractive yield pick-up for the additional credit risk assumed. Today the same bond would pay you 0.18% *less* than the equivalent government bond! It needs little explanation then that the best strategy for investors has been to reduce credit exposure steadily over time – for example it peaked in the M&G Bond Fund at over 70% in 2008, and it is now close to zero.

Consequently, the other two levers – duration and curve positioning – have become greater performance drivers as market conditions changed. Duration positioning has the potential to generate significant performance, although the return profile can be quite "lumpy" in contrast to the steadier return profile delivered by credit (assuming you avoid defaults). It is also more at risk from macro events that are difficult, if not impossible, to foresee such as the infamous 'Nenegate' or Covid-19. Curve positioning, on the other hand, allows one to exploit relative mis-pricings on the yield curve without necessarily exposing a fund to changing levels of the yield curve. Over the last 18 months, yield curve positioning has been a key driver of the M&G Bond Fund's performance, and we expect this to remain true as we continue to find good opportunities in this space.

To conclude, we think domestic bonds currently present investors with an attractive opportunity, given the elevated real returns on offer. They merit consideration for inclusion in investors' diversified portfolios – particularly those investors who may be holding too much exposure to cash.

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