M&G Investments

Quarter 4 2022

Consider this

Contents

Chris Sickle
Chief Executive Officer

Letter from the CEO

Reflecting on the unexpectedly turbulent year that was 2022, our investment team was put to the test on numerous occasions, and I have been proud to see them stick to our long-held investment process and prove their mettle. Although absolute fund returns for clients have unfortunately been lower than average on a historic basis due to the difficult economic and financial conditions, our relative SA fund performance for the year to date (to 20 December 2022) shows how successful our equity, fixed income and property investment teams have been: all of our rand unit trusts (excluding global funds) outperformed the average fund return in their ASISA categories. This encompasses income funds, multi-asset funds, property funds and equity funds. Several were ranked among the top 25% in their categories over longer-term periods as well, including the M&G Equity Fund, M&G Dividend Maximiser Fund and M&G Balanced Fund.

SA fund outperformance in 2022

Our stock-picking skills came to the fore once again. As a good example of our SA equity selection, the M&G SA Equity Fund recorded excellent alpha (above-market performance) versus the FTSE/JSE Capped SWIX Index for the year to 20 December with an 8.2% return versus 4.7%. The fund's benchmark, the average of the ASISA SA Equity General category, returned 3.5% over the same period.

Equally, we were correct in our multi-asset funds' asset allocation choices with our preference for local stocks and bonds over their offshore counterparts – this proved to be a key decision as these local assets strongly outperformed global equity and bond indices over the period. In fact, rand asset outperformance was a clear theme for most of 2022, with offshore assets providing little downside protection. Given the MSCI ACWI's net US dollar return of around -18.7% and the S&P 500's -18.5% net return year to date, even US dollar appreciation of around 8.5% against the rand couldn't lift US dollar returns into positive territory for rand investors.

This offshore weakness created the perfect "trap" for investment managers who immediately decided to increase the global asset weightings in their portfolios in response to February's lifting of the Regulation 28 offshore asset limit for retirement funds from 30% to 45%. We instead refreshed our modelling of strategic offshore allocations, running numerous scenarios to ensure robustness. We concluded that, under the most plausible outcomes, around a 30% long-term (strategic) foreign currency allocation remains appropriate. Equally, we opted to keep our portfolios underweight global assets in the short term (tactically) due to the much more attractive valuations of SA assets at the time. However, we did begin adding more offshore asset exposure in the second half of 2022 due to their underperformance versus South Africa, so that we are now more neutrally positioned at the end of the year.

Political risk abates

In a surprise-filled year, the last (significant) event we encountered was December's market sell-off, prompted by reports that President Cyril Ramaphosa was considering resigning in response to findings by a Parliamentary panel that there was prima-facie evidence of him having committed impeachable offenses related to the Phala Phala robbery. Once again, we didn't start selling SA assets, but instead monitored developments closely and watched for any changes in longer-term financial fundamentals – which never materialised. The situation was resolved at the party's elective conference in mid-December, as the vast majority of the ANC rallied behind Ramaphosa and the President emerged even stronger than before. SA bond yields, which had jumped as a result of the elevated political uncertainty, gradually returned to near their previous levels and the rand strengthened, showing why we always focus on longer-term fundamentals during these short-term episodes.

2021 Stewardship Report

I'm pleased to report that in December we launched our 2021 Stewardship Report, as we continue to report on our approach, priorities, activities and accomplishments regarding the responsible stewardship of our clients' capital for the past year. I urge you to read it online, as we relate some interesting examples of our company engagements, voting dilemmas and key themes. With a global footprint, we are able to take full advantage of our global M&G colleagues' expertise and advanced information systems to improve our own data collection and deepen our understanding of the global environment in which our investee companies operate.

We have been even more active in 2021 than in previous years, in face of the serious ongoing socio-economic challenges exacerbated by the Coronavirus pandemic, such as poverty, unemployment and inequality, as well as the urgency of combatting environmental challenges. Environmental, Social and Governance (ESG) factors and other sustainability considerations have been playing an even more impactful role in our investment process and active portfolio management.

Going into 2023

As is often the case, going into the new year we are faced with mixed conditions. It is easy for SA investors to be bearish given the news headlines, but there are positive factors to be aware of. On the bearish side globally we have elevated uncertainty, as we wait to see where inflation and interest rates eventually peak, and growth troughs. Stagflation and/or recession are possibilities in certain economies like Europe and the US (to a lesser extent), and even China is facing exceptionally slow growth prospects amid a resurging wave of the Covid virus. Additionally, Russia's tragic war against Ukraine drags on with no resolution in sight, with its destruction and dislocations of people and trade, not to mention Europe's energy crisis.

On the positive side globally, there are signs we are getting closer to the end of the rate-hiking cycle: US inflation peaked some time ago, the US Federal Reserve reduced its December interest rate hike, and the market expects a pause sometime in the first quarter of 2023, bringing greater clarity to the outlook. Equally, businesses are dealing more adeptly with supply chain disruptions and energy prices have fallen from their peak levels. Investors appear more confident around company earnings going forward, leading to the equity rallies we experienced in October and November. Equally, there are pockets of attractive equity valuations, but investors need to be selective.

In South Africa, we are also confronting high inflation and interest rates and low growth prospects going into 2023. Continuing power outages are also weighing heavily on businesses and consumers. On the positive side, inflation is falling and further interest rate increases are expected to moderate, broadly following the lead of the US. Equally, political risk has abated. For investors, we believe SA equity and nominal bond valuations are attractive when considering the risks involved, reflecting overly pessimistic views on risk, so we would expect these assets to deliver above-average returns over the medium-term from current levels.

Investors should continue to be discerning when it comes to SA equities, however, and choose those companies with strong balance sheets, management teams already proven to produce reliable results in uncertain, low-growth conditions, and companies able to pass on price increases to consumers and suppliers amid inflation that could remain higher for longer. These defensive characteristics should improve the performance of investor portfolios. Our portfolios are positioned along similar lines, and we are confident that, as we did in 2022, we should be able to produce alpha for our clients in 2023. Remember to stay the course, look to the longer term, and keep investing according to your financial plan to be successful in the new year.

Sincerely,

Chris Sickle

Chris Sickle
Chief Executive Officer

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

- More global research these days substantiates the value-added to investors by financial advisers, which has been quantified.
- Their value-add comprises better savings discipline, tax efficiency and asset allocation and, most importantly, behavioural coaching to avoid costly mistakes.
- The current volatile market conditions, where SA investors are likely to be reluctant to invest in higher-risk assets, are ideal for advisers to add value. SA equities and bonds represent good value for long-term investors, and advisers can help clients both overcome their reluctance to buy them and stay the course over time.

Q **I've seen that you often advocate for investors to use qualified financial advisers, rather than going it alone in their investment journeys. But do they add value beyond the fees they charge? Is their advice really worth it?**

A **The value of advice is quite difficult to quantify, as it** covers a very wide range of aspects. However, these days there is a substantial body of global research that demonstrates measurable, quantitative value for financial advice. There is considerable evidence that this added value for investors derives from various aspects, including improved savings discipline, tax-efficient structuring, better asset allocation decisions and behavioural coaching to avoid costly mistakes. In addition, the better results from advised investing contribute to greater peace of mind for those clients, more success in meeting financial goals, and better preparation for retirement and emergencies, all non-quantifiable benefits that are, in fact, invaluable.

Evidence of value added

Most recently, the November 2022 Whitepaper "Financial Advice in Canada" highlighted several different studies(1) that affirmed the value of financial advice. Perhaps the most well-known of these is the Russell Investments' "Value of an Advisor" study, conducted annually in the US for several years now. In its 2022 report, Russell found that the approximate value of a financial adviser to their client was 4.91% – in other words, they added a net 4.91% to a client's total return for the year. They broke this total value into four components:

1) 2.37% from behavioural coaching – preventing clients from moving to low-risk assets or selling out of their portfolios during market downturns, and therefore locking in losses;

2) 1.22% from tax-efficient investing and planning;

3) 1.21% from informed asset allocation choices and family wealth planning (involving insurance, accounting, trusts, etc); and

4) 0.11% from active portfolio rebalancing.

Other interesting US research found that those investors with financial advisers prior to the 2008 Global Financial Crisis (GFC) on average lost significantly less money (6.25% less) and experienced less wealth volatility than unadvised investors, after accounting for the level of risk taken, partly because they were less likely to make costly mistakes like selling equities in a downturn (Grable & Chatterjee, 2014).

In Canada, the “2022 Mutual Fund and ETF Investor Study” released jointly by the IFIC and Pollara in October 2022, found that 80% of unit trust investors and 73% of Exchange Traded Fund (ETF) investors stated that they believed they received a better return on their investments due to the advice they received from their adviser, with 74% and 64%, respectively, saying they had better saving and investing habits due to them.

Another study, the “Value of Advice Report” by Canada’s CIRANO Institute in 2018, found that after 15 years of investing, advised investors had accumulated 2.3 times more assets compared to their unadvised counterparts. And even after only four to six years of investing with an adviser, clients had built up 1.58 times more assets. The factors identified as contributing to this better outcome were higher savings rates, a higher allocation to non-cash investments (i.e., high allocation to risk assets in order to match longer term liabilities), and better disciplined behaviour through market downturns.

No time like the present for an adviser

It makes sense that in South Africa financial advisers can add at least as much value as in these developed country studies – and since our financial markets experience even more volatility due to their higher levels of risk, financial advice could conceivably be even more valuable. The current investing conditions are ideal for demonstrating this value, both in terms of actual investment returns and less quantifiable types of support. This is because periods like this – with most asset valuations cheap after having sold off through much of 2022, and market conditions highly uncertain and volatile – have been found to be when financial advisers can add the most potential value to client outcomes.

South African investors are understandably nervous and worried about the gloomy economic conditions both locally and globally: slow growth (and a possible global recession in 2023) paired with high inflation and interest rates are top-of-mind. Exacerbating matters is that 2022's poor performance follows several years of pain from disappointing market returns already (especially longer-term domestic market returns), as Graph 1 shows, making investor sentiment even worse. No one wants to see their investment values continuing such low growth or even falling further. This type of fearful mindset makes it easier to succumb to common human behaviours like short-term thinking, acting out of emotion, selling assets when markets are down, and being too conservative in investment choices. This is where behavioural counselling by a financial adviser can help you avoid costly mistakes like these, and to stay invested during the perpetual ups and downs of financial markets over time.

Graph 1: Investors taking pain from disappointing SA equity returns

FTSE/JSE All Share Index Nov 2007-Nov 2022

Source: Morningstar

Biting the bullet to buy risk assets

Investors are probably wondering how best to position their portfolios going into 2023. An adviser can help you answer this question by guiding you in your asset allocation and choice of unit trust funds most appropriate for your personal financial goals and investment timeframe. As the surveys highlighted, in many instances they have add value by helping their clients avoid overly conservative portfolio positioning, instead allocating less to cash and more to assets that can outperform inflation like bonds and equities than unadvised investors would in the same circumstances. This allowed them to better capture the higher prospective returns from these riskier assets.

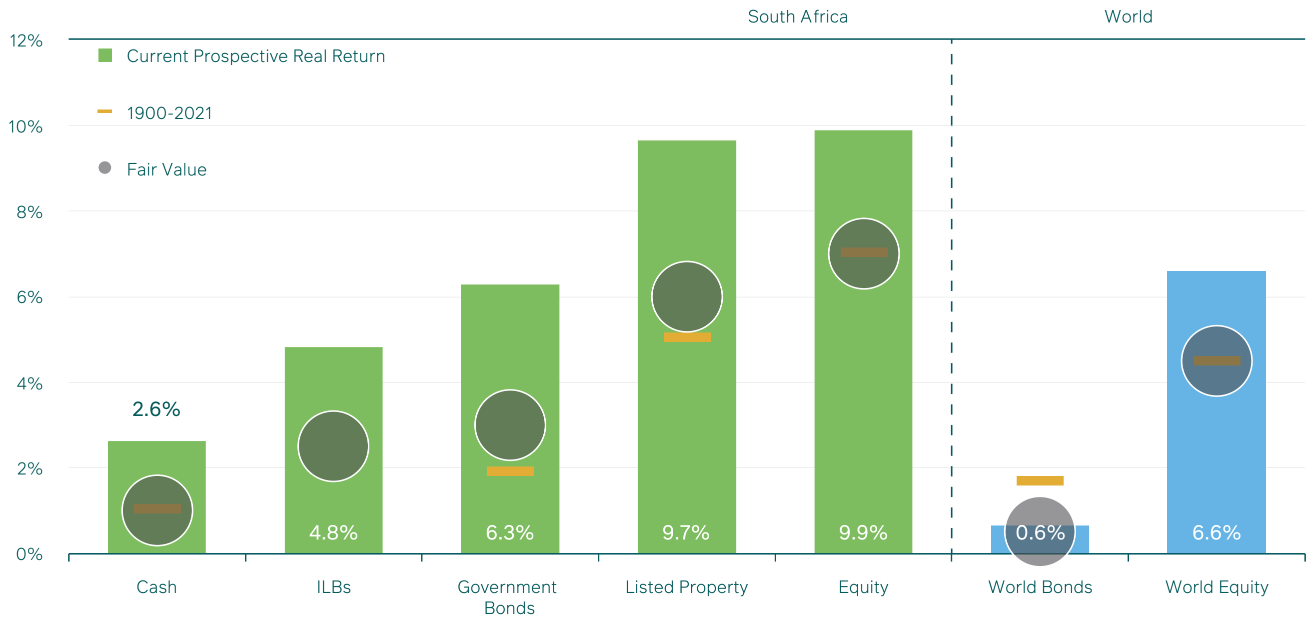
In our view, for longer-term investors, based on the SA equity and bond valuations at the time of writing, it is worthwhile adding local equities and SA government bonds to your portfolio due to their attractive valuations compared to history and relative to many other assets. Our client portfolios reflect our preference for these higher-risk assets compared to most other asset classes – we think their prospective returns are worth the risk involved in holding them. And if you do hold riskier assets, then a financial adviser can help you stay the course and enjoy their full benefit over time.

Taking advantage of cheap valuations

As valuation-based investors, we are less concerned about the current bearish macro factors – although we do pay attention to them – and more focused on investment valuations, where we have good reason to be cautiously optimistic about investor prospects going forward. In our view, SA equities and bonds are offering attractive (well above-average) prospective returns for the risk involved in holding them going forward. We would therefore suggest it would be a mistake for longer-term investors to avoid SA equities and bonds in the present conditions, despite the negative news that dominates.

Graph 2 illustrates our high-level estimates of the prospective real returns from different asset classes based on their current valuations. As a brief overview, you can see that South African equity has the highest real return potential at 9.9% p.a. over the medium to long term, compared to its historic average (fair value) of 7% p.a. SA listed property is also very attractive, but we are more cautious on these assets as our in-depth analysis suggests they come with higher risks to prospective earnings than other equity sectors.

Graph 2: Prospective real asset class returns from current valuations



Source: Bloomberg, Credit Suisse, M&G Investments 07.12.2022

Additionally, South African government bonds stand out for their high prospective real return of 6.3% p.a., more than double their historic average of 3.0%. In our view, investors get handsomely rewarded for their associated risks. This is why, going into 2023, we prefer both South African equities and bonds over other local asset classes.

To benefit requires courage and patience

For investors to be successful in taking advantage of these excellent valuations, however, there are some personal qualities they require – the courage to buy assets like equities that have underperformed and disappointed in the recent (or even not so recent) past, and the patience to wait out market downturns and hold these investments until their prospective returns are delivered. No one knows the future trajectory or timing of financial markets, and history shows that it can take years for these “riskier” investments to pay off. But in the end they have done so, as Graph 2 confirms.

This is where the importance of having a financial adviser comes to the fore. There are few people who can stand to suffer financial losses, without being tempted to run for safety. Most need a partner throughout their investment journey who can offer their expertise in deciding how to invest through time, while also helping curtail the often-self-destructive human instincts that emerge along the way. We are all human and prone to the same behavioural mistakes. That is exactly where having a “sounding board” or “financial coach” can help you most.

In conclusion, if you don't already have a financial adviser who has proved their worth, make sure you find one. Do your homework on the adviser, just as you would for any other professional service provider (lawyers, accountants, builders, etc.) to make sure they're properly qualified and experienced. Then, even though you never know what's to come in the investment universe, you'll have greatly enhanced your chances of reaping the rewards of investing.

Appendix:

1. https://www.ific.ca/wp-content/themes/ific-new/util/downloads_new.php?id=27821&lang=en_CA;
2. https://russellinvestments.com/Publications/US/Document/Value_of_an_Advisor_Study.pdf
3. https://cirano.qc.ca/files/publications/2020RP-04.pdf
4. https://www.pollara.com/wp-content/uploads/2022/10/IFIC_2022_MF_ETF_Investor_Study.pdf

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

Stefan Swanepoel
Equity Analyst

A slow burn for SA's new rapid payments system?

Key take-aways

- Investors might assume that the impending introduction of a cheap and easy new cashless payments system will be negative for our large commercial banks, since clients will switch away from their more expensive, higher-margin products.
- We believe the actual impact will be more nuanced. If the system is priced correctly, lower-income consumers will be most likely to adopt it, while middle- and higher-income clients may use it but still retain their credit and debit cards thanks largely to loyalty programmes.
- If many participants in SA's large informal economy use the system, more of their financial activity will be brought into the formal economy. Some will eventually trade up to higher-margin banking products, benefiting banks all around.

Consumers and business owners may be starting to get excited about the introduction of a Rapid Payments Programme (RPP) in South Africa, which is expected in the first quarter of 2023 under the guidance and regulation of the South African Reserve Bank (SARB). The new digital system, developed collaboratively between the larger local banks, will offer a cashless, simple, near-frictionless and cheaper way to conduct real-time transactions for anyone with just a cell phone number or even an email address.

Just think: no more waiting in long queues to deposit or withdraw cash, and no more piles of cash at day-end. No more days-long delays for much-needed payments to clear. No need to scramble for coins or small bills to tip the car guard or petrol attendant; instead, pay immediately by transferring digital rands from your phone to theirs. Merchants are also set to benefit from lower transaction costs, and e-commerce sales will become less expensive and complicated without the complex fraud verification charges of credit cards. These are just some of the more obvious benefits of the RPP.

> "Just think: no more waiting in long queues to deposit or withdraw cash..."

While South Africa was historically a trend-setter in developing one of the first real-time interbank payment systems back in 2006, it has been focused more on the high-value and low-volume transactions. Despite offering payments within a mere 60 seconds, it is expensive to use and hence its adoption has been very low. It also focuses on bank-to-bank payments, something the RPP seeks to address over time.

How will it work?

The system has been tailored for smaller value and higher volume payments, based on advanced technology used in a simple architecture to keep costs as low as possible. To make a payment using the RPP, the user will send a message to a recipient's email address, mobile phone number or bank account with the payment amount. Upon receipt, that amount will immediately reflect in the recipient's account, to be used later for their own digital payments. It can also be converted into cash again if needed, by transferring it into a bank account and withdrawing the funds via an ATM.

What is different about the RPP is the fact that the payer will bear the cost of the transaction, which is expected to be as low as 0.10%-0.30% of the total payment value – substantially cheaper than cash withdrawal charges. Although it will not be completely free as in some other countries like India, it will certainly be cheaper than the 1.5%-2.0% charged by credit cards like Visa and Mastercard, or the even more expensive fees charged by the likes of an American Express or Diners Club. However, these credit card charges are generally borne by the merchants who accept these methods of payment. Banking clients are actively incentivised via loyalty programmes like FNB e-bucks, Absa Rewards and Standard Bank UCount to make use of their credit cards as the preferred method of payment.

In addition to accepting normal payments, RPP will also allow for send-to-receive payments. These are instances where in the shops, the buyer will give the vendor their cell phone number, and the vendor then sends a payment request to them for the buyer's approval.

From the vendor's perspective, vendors are incentivised to join the new system because it is so much cheaper than them having to pay the fees charged by banks to process credit or debit card transactions (discussed above).

One largely unknown factor at this stage is the security risks to these transactions and to individuals' accounts on their cell phones or emails. There is certainly some capacity for fraud – it is possible for hackers to gain access to someone's phone or email account with potential uncertain consequences at this point. One potential mitigant that the SARB could introduce to address this risk would be to limit payment values, at least to start with, to reduce incentives for fraudsters. We understand the initial transactions will be capped at R3,000.

Boon or bust for banks?

Who wouldn't been keen about the advent of the new system? At first glance, SA banks and their investors, given that the banks earn high fees and margins from the country's existing payments set-up, and the RPP is a lower-margin service. Additionally, it uses open architecture that will ultimately allow non-banks access to the payment infrastructure, creating even more competition. It is easy for analysts to assume that the lower cost of the cashless option will encourage droves of bank clients to switch immediately to the new system and give up their existing higher-margin bank products.

> "...based on evidence from several other countries, there are strong incentives for the existing structures to remain in place... "

However, in our view, this would be an incorrect assumption: based on evidence from several other countries, there are strong incentives for the existing structures to remain in place. In the first instance, the existing bank reward structures typically ensure that transactions like credit card payments not only remain relevant but grow. In the second instance, the low value/high volume nature of the RPP system has been very effective in capturing a large part of the existing cash-based activities. This increases the overall pool of electronic money in the system and more importantly the velocity of the transactions. Key to this is the pricing of the service. The cheaper the service, the better its take-up.

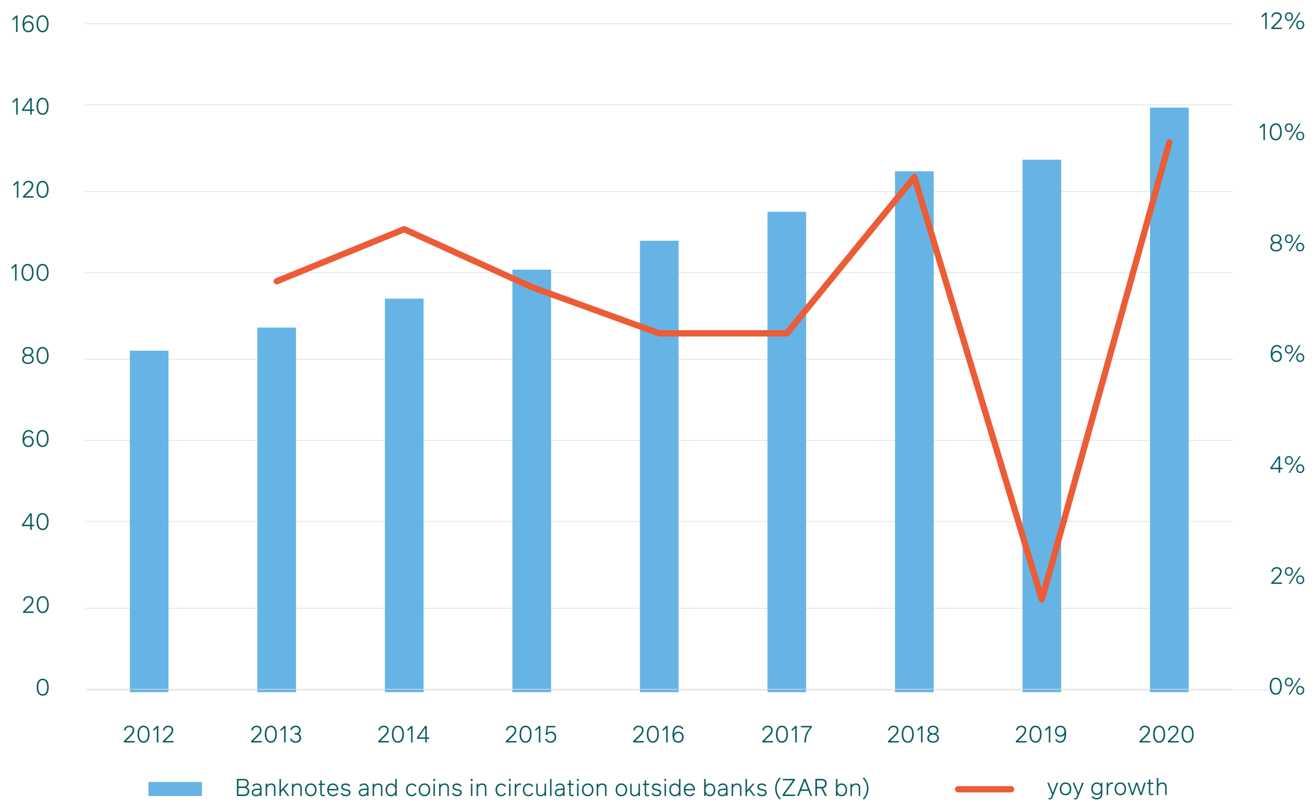
If we look at the examples of India and Brazil, their rapid payments systems have proved to be huge successes. They kept infrastructure costs low and were able to price their services at appropriately low entry points to make them accessible to the lower end of the pyramid. The simpler infrastructure has also allowed the systems to expand more easily, being taken up not only by individuals, but also by shops, medium-sized businesses, informal traders, and many other participants in the informal economy.

Meanwhile, in places like Europe rapid payments have not been as successful. The primary consideration there has been the pricing of their systems, which proved to be inappropriate to incentivise a true transition away from the cash economy.

What about South Africa?

In South Africa, estimates show that just over half of all point-of-sale purchases are still made using cash, while in the informal economy nearly 90% of transactions are cash-based. It is clear from these numbers that the existing payment methods have proved too expensive, too difficult, or do not offer enough value for the average South African. Equally, banks have been less focused on offering affordable services to the lower-income segment of the market, or small businesses, due to the high costs of providing these services, although the traction gained by the likes of a Capitec in capturing this market segment has been a notable exception in recent years. But even their simpler, lower-cost services have not managed to convert many of those operating in the informal economy. Graph 1 shows how cash levels circulating outside of the banking system just keep rising despite South Africa's relatively sophisticated financial infrastructure.

Graph 1: Cash outside SA's banking sector continues to grow



Source: Bank for International Settlements

In fact, to persuade more people to move away from cash, the RPP needs to be affordable enough to outweigh the benefits of avoiding taxes, simple enough to be almost as convenient as cash, while also overcoming questions around distrust of new technology. The feature of its greater security than holding and transporting actual cash certainly works in its favour. Based on what we know of the service so far, we believe the RPP does have a good chance of eventually attracting many users like the average taxi driver or shop owner.

There is certainly a tremendous opportunity for an affordable digital payments system to gain traction. According to Stats SA, the country has some 1.8 million informal traders, of whom 80% do not use banks at all. And of the 20% who do have a bank account, the majority only use it to process payments. However, most South Africans do use a cell phone. Adoption of the digital option could prove transformative for many users such as small, rural traders, for example: cash flows can be tracked on a near real-time basis, without settlement delays, resulting in more efficient timing for stock orders and management and, consequently, more rapid growth for these businesses. This so-called "lazy money" will become more productive. And let's not forget the broader economic benefit for the South African economy of having cash transactions become trackable by the tax authorities. Even if many users remain below the VAT threshold of R1.0 million turnover, income tax collection becomes possible, and the transaction records can prove to be an invaluable source of information on which to base government policies.

Gradual adoption won't materially impact SA banks

However, in our view the adoption of RPP will take time, and it is not likely ever to fully replace cash as a transaction medium. We also don't believe it represents a material risk to banks' profitability. This is because the RPP is designed largely for the lower-income segment of the market, where the big commercial banks have few higher-margin clients to lose. Also, banks are likely to be able to retain their middle- to higher-income debit and credit card clients who appreciate the benefits of loyalty programmes and not having to carry cash. While these clients may opt to use the RPP occasionally for smaller payments in circumstances where credit cards aren't possible, they are likely to keep their cards for their convenience and their ability to protect against any fraud. Electronic fund transfers (EFTs) will also remain a competitor for the RPP.

> "We also don't believe it represents a material risk to banks' profitability. "

Lastly, another important point possibly overlooked by analysts at first glance is the positive knock-on effect of gradually bringing so many informal market participants into the formal economy over time. First, there is the expected boost to growth from improved efficiency and productivity, and lower security risks as mentioned above. Second, experience in other countries has shown that as people become comfortable with using technology to transfer funds instead of having cash in hand, they also become more open to adopting more sophisticated banking products. This can help banks gain more trust and acceptance among lower-income South Africans and small businesses, and in turn broaden their client base as they sell up their value-added product chain with higher-margin products. Expanding the formal economy can only be positive for our banks over time.

In conclusion, we are looking forward to seeing how the market greets the new system in 2023. Its introduction first by three of the bigger banks, as the most advanced in finalising their architecture, will give them first-mover advantage to some extent. Our M&G house view portfolios remain overweight the banking sector thanks to their attractive valuations and the benefits of higher interest rates (the endowment effect), as well as banks' high levels of provisioning (continuing from the pandemic period) that are now being used to offset pockets of rising bad debts. As noted above, we see the RPP as introducing some positive opportunities for the sector as well, given the current extent of the cash economy.

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.

Analysis


iStock-1341484868

Aadil Omar
Head of Equity Research

The state of healthcare: All the running you can do

Key take-aways

- SA's healthcare system has faced escalating costs which listed hospital companies have largely had to absorb in recent years, resulting in declining profit margins.
- The reality is that competing priorities are at work: to make the system as far-reaching as possible and maintain a minimum standard of service, costs will necessarily need to rise as populations age and grow. But costs must also stay within the reach of ordinary people.
- Innovation is helping the sector succeed in improving living conditions and longevity, but it requires maintaining a continuous delicate balance between competing interests to be successful. This is equivalent to having to run a little bit faster just to maintain what has been accomplished.

"Alice looked round her in great surprise. 'Why, I do believe we've been under this tree the whole time! Everything's just as it was!'

'Of course it is,' said the Queen, 'what would you have it?'

'Well, in our country,' said Alice, still panting a little, 'you'd generally get to somewhere else — if you ran very fast for a long time, as we've been doing.'

‘A slow sort of country!’ said the Queen. ‘Now, here, you see, it takes all the running you can do, to keep in the same place.

‘If you want to get somewhere else, you must run at least twice as fast as that!”

— Lewis Carroll, Alice in Wonderland

In Lewis Carroll’s famous fairy tale, the Red Queen faces the dilemma of having to run ever faster just to remain in the same place. I’m sure you can think of many businesses facing the same pressure, especially in South Africa with escalating costs driven by the electricity crisis and inflation more generally. The healthcare sector has been no different, and the last few years have been particularly challenging for an industry that is resilient to the ebb and flow of a business cycle.

The constraints are intuitive

The social requirement of most modern healthcare systems - at least the version we are promised by politicians - is a universally accessible, prefunded, and free at the point of care service. Alas, very few places can achieve such a demanding objective (we will discuss some of the pressure points in the paragraphs that follow). There is, however, a simple and intuitive framework we can work with to understand why these lofty goals are largely out of reach. Healthcare systems embed a trifecta of competing priorities, namely:

1. Accessibility to the system: to be as far-reaching as possible, ideally national coverage;
2. Cost of care: to be minimised, or remain within a budget; and
3. Quality of care: to maintain a minimum standard of available care.

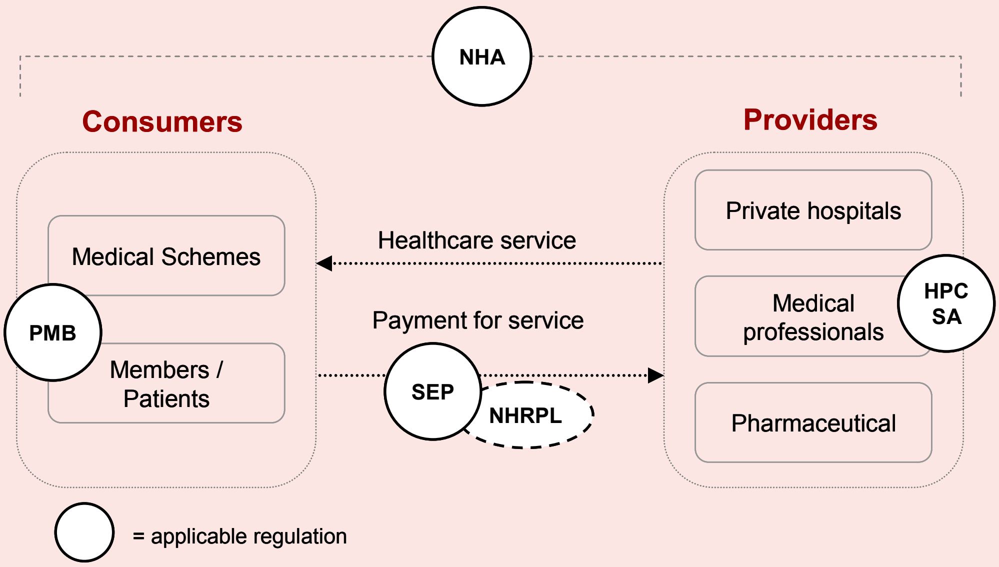
Like many of these trifectas, you can often aim for two out of three, but you cannot optimise for all three. For example, if you want to increase accessibility without compromising on quality, you incur greater cost. To keep the cost of care unchanged while increasing coverage, quality of care will be compromised. In the case of healthcare, the most unrelenting of these is cost of care: it is sticky-down, tending to creep up easily and remain stubbornly high.

And then it gets complicated

Healthcare systems embed numerous stakeholders, each with their own needs and protecting their own interests. The incentives at play are not always easy to align, and depending on the stakeholders, they could be opposed. For example, as economic agents, healthcare providers have a profit maximisation motive (doctors, hospitals and pharmaceutical manufacturers), while both the state and the medical aid schemes seek to reduce the payments to service providers. By reducing costs, funders can expand coverage and/or improve quality of care.

Healthcare is also among the most regulated sectors in a modern economy, with legislative and regulatory mandates seeping into everything from product pricing and employment rights to defining healthcare benefits.

SA Healthcare System



NHA: National Health Act – Regulates national health across both the public and private sectors with the objective of providing uniformity of health services across the nation.

PMBs: Prescribed Minimum Benefits – Defines the minimum level of benefits to which all medical scheme members are entitled, regardless of the benefit option to which they belong. PMBs are a function of the Medical Schemes Act and cover all emergency conditions, 270 medical conditions and 25 chronic conditions such as epilepsy, meningitis, lung cancer, etc.

Single Exit Pricing: (SEP) – Aims to provide consumers with a transparent pricing system for medicines by regulating the price of medicines. SEP effectively removes all discounts and levies on medicines and regulates the dispensing fee chargeable by providers.

NHRPL: National Health Reference Price – Provides a reference for costing of healthcare services. The NHRPL is not meant to be a recommendation for pricing but has gained more relevance than a reference list since the publication of the draft National Health Amendment Bill.

HPCSA: Health Professionals Council of South Africa – Governs the practise of medicine and allied professions in South Africa under the Health Professions Act.

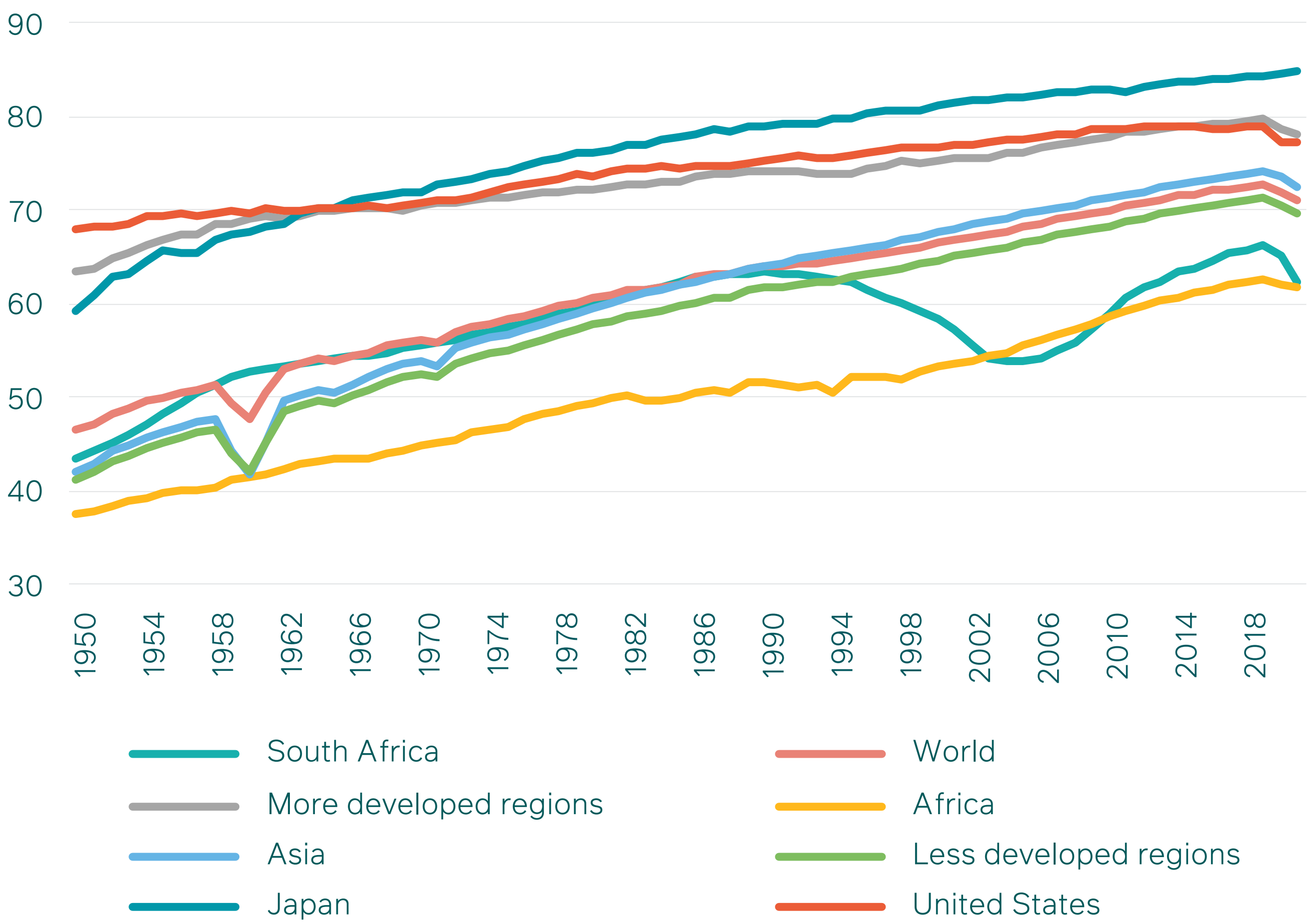
Many sectors are regulated and embed agents with competing interests, but what has always struck me as unique in healthcare is that the agent making the purchase decision (the medical aid scheme or funder) is not the person consuming the service (the patient). Readers familiar with the insurance industry would rightfully point out that most insurance products are structured this way. However, healthcare is not a standardised product; when your vehicle has a bent fender it is obvious what repair is required. But when you walk into a doctor's room with abdominal pain, your treatment path could range from a simple course of antibiotics to an investigative CT scan. The decision as to which treatment path is followed is a collective one, and the loudest voices in room are the doctors and the funders. This is not a judgement on the process, but rather an illustration of the varied interests at play in almost all cases involving the healthcare system (public or private). In fact, incentives are perfectly clear when viewed through the lens of each individual agent.

Geriatrics are a sign of progress

I think you would agree that the system is complex and requires a fair bit of skill to manage successfully. It is therefore no small feat that by any measurable data series, as shown in Graphs 1 and 2, healthcare systems and the advancement of medicine have delivered incredible (and ongoing) outcomes through time. Human beings across all income categories are living longer than at any other time in recorded history; the prevalence of death among children as compared to the adult cohorts has plummeted over time. These are not small achievements for humanity.

Graph 1: We are living longer

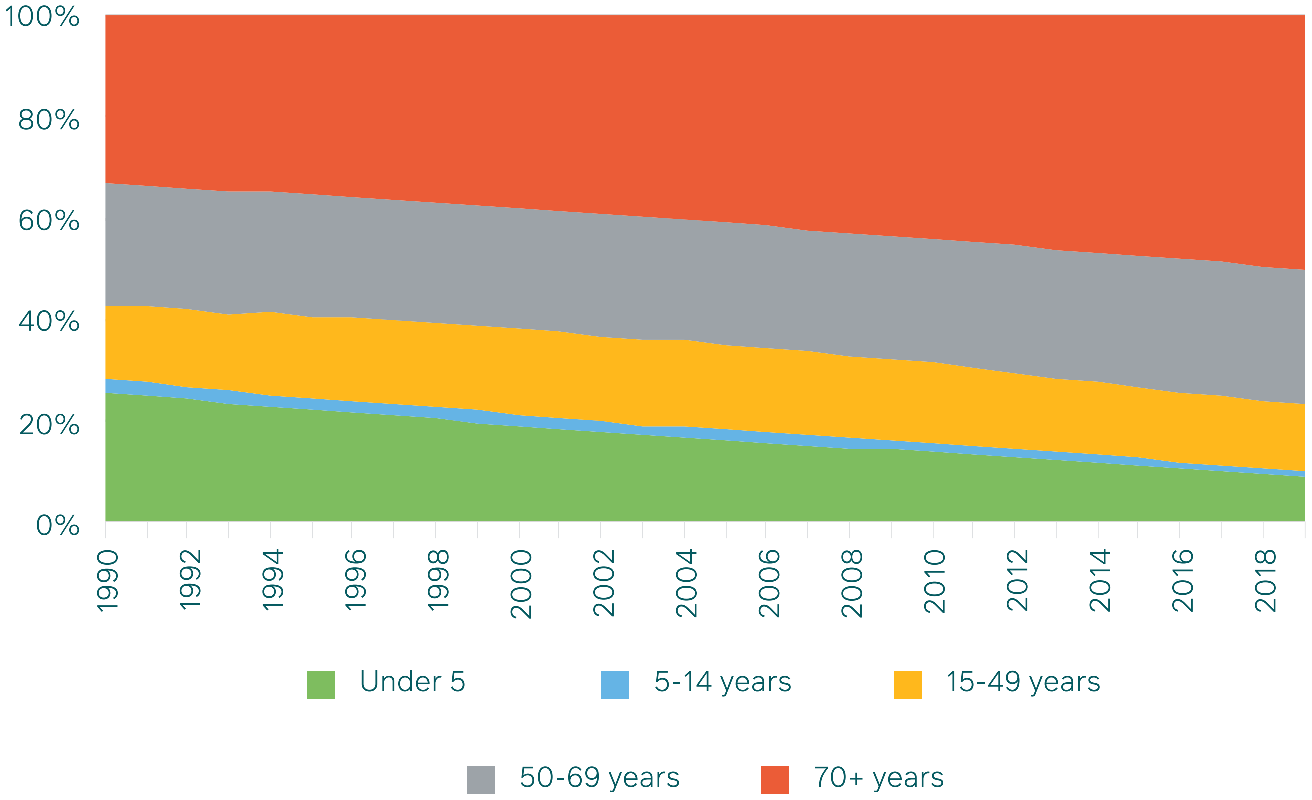
Life expectancy at birth (years)



Source: ourworldindata.org

Graph 2: Dramatic drop in child deaths

Proportion of deaths by age cohort (all causes)



Source: ourworldindata.org

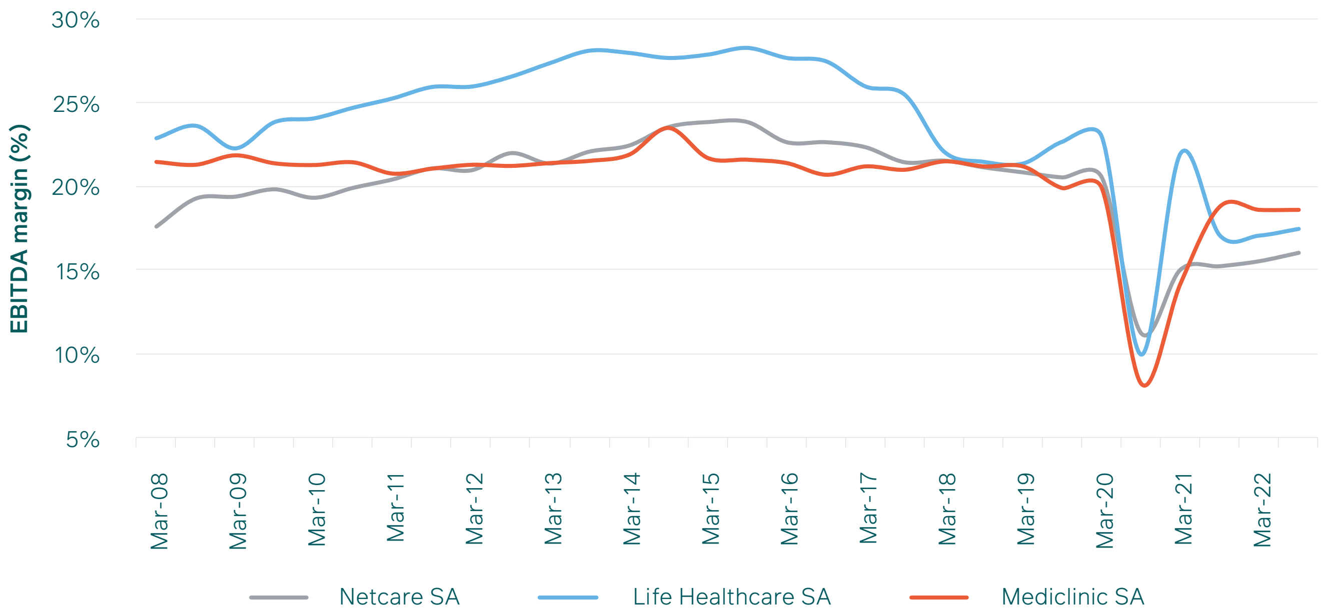
Healthcare lives in Red Queen country

As healthcare has become more ubiquitous and countries have prioritised coverage, the demands on already-constrained funding pools have served to constrain some participants in the value chain. The organic drivers of an aging population and a growing burden of disease further exacerbate the cost burden – older and more sickly people are more expensive to treat.

No doubt, if you are a member of any medical scheme or you've paid for healthcare out of pocket, you might well argue that your rands do not stretch very far as price increases are significant every year. It will probably not console you much to learn that cost pressures are widely suffered in the healthcare services sector, and the pain is felt across many providers in the value chain.

Take the hospital operators for example – all three of the JSE-listed companies (Netcare, Life Healthcare and Mediclinic) have suffered a material dilution of profit margins (as highlighted in Graph 3): the costs underlying provision have proved too much to recoup from funders. And as we can see from the graph, their margins have been falling since about 2015, and have not fully recovered from the dramatic drop experienced during the worst of the Covid crisis.

Graph 3: SA hospitals' profit margins declining since 2015



Source: Netcare; Life Healthcare; Mediclinic

For some time now, bargaining power has been accruing to medical schemes at the expense of healthcare providers, both doctors and hospitals. Funders are becoming more sophisticated in the way healthcare is both delivered and paid for, with interventions such as active case management now common practice. Healthcare does indeed live in Red Queen country, with just about everyone needing to run a little faster simply to maintain their position.

Imagination is not the solution, there is too much at stake

What society requires from the system is akin to the search for a perpetual motion machine – we want healthcare to be the highest quality, available to all citizens and we want that at an affordable price. As this article has detailed, the expectation is unreasonable, considering the variables at play and the configuration of the system.

It is tempting to suggest we re-think the configuration of the system from the ground up, and you have probably heard the debates around National Health Insurance (NHI) as the prime actor in the debate. Healthcare provision is central to modern economies, and at the extreme, a functioning system is a matter of life and death. Risk aversion is therefore built into the structure of a functioning system and the "reimagine" approach – popular among start-up founders and populist politicians – is of no practical use. In the case of South Africa, neither a solution rooted in nationalism nor one structured purely on a profit-at-all-costs basis will adequately address the (growing) need. We must work from our current position and that will always be a delicate balancing of the trifecta of priorities.

Innovation is healthy for healthcare

Healthcare has never been a stranger to innovation, both in the treatment and risk management of care, as well as the funding thereof, and we think that the sector will continue to evolve. Based on our observations of the sector, we identify two related trends that, we hope, could help improve both outcomes and access for more people:

1. Re-assignment of risk: The last decade has seen increased responsibility for outcomes placed on the shoulders of healthcare providers through managed- and value-based care initiatives. In plain language, a healthcare provider such as a clinic is paid an all-in treatment fee for a patient for a year (by a funder) instead of a per-service fee every time the patient visits the clinic. The responsibility and risk for managing the patient's treatment pathway and associated costs falls on the clinic and not the funder.

2. Access through niche financial products: Medical aid schemes are obliged to support members with certain minimum healthcare benefits regulated under the Medical Schemes Act (known as Prescribed Minimum Benefits or PMBs). Maintaining adequate funding to support members with PMBs makes medical aid expensive. In recent years, however, we have seen a marked increase in alternative products to support healthcare needs not subject to PMBs. These include products for specific care such as maternity, or to help patients fund the cost of medicines. This is an area where we could improve both access and care through dedicated financial solutions.

Balancing the trifecta of competing priorities will be a permanent feature of any managed healthcare system, and it seems we're destined to reside in Red Queen country for the foreseeable future. However, innovation is also a mainstay, and if the trends of the last seven decades persist, the 60's could well be the new 40's for us all.

Aadil joined M&G Investments in July 2013 as an Equity Analyst. In August 2018 he joined a global equity hedge fund in London, before returning to M&G Investments in January 2020 as Head of Equity Research. With 15 years' investment experience, Aadil's qualifications include a BCom degree (Hons, cum laude) from the University of Pretoria and a Masters in Finance degree from INSEAD. He is also a CFA charterholder.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Analysis

Anthony Walker
ESG Specialist

Unbundling, untangling and recycling: Questioning director independence

Key take-aways

- When vetting candidates for Director positions, we have found that the Boards of many SA-listed companies have an inadequate number of truly independent non-executive directors (NEDs).
- There is a shortage of qualified candidates because few people have served on Boards previously, and “professional” NEDs often lack the operational experience necessary to help guide Board members in their decisions.
- We have found that Boards can be lax in conducting due diligences. Some have failed to uncover conflicting connections between NED candidates and their companies.

Unfortunately, a common theme for M&G Investments in our role as a responsible steward of our clients’ investments has been the presence on listed companies’ Boards of non-executive directors with questionable status as “independent”. Even as this article is being written, Business Day’s front page features an article about a former CEO of international retailer Spar becoming an “independent non-executive director” amid reported questions over his independence.

The role of independent non-executive directors (INEDs) is critical to the functioning of an entity. INEDs on a properly functioning board are a source of experienced, deep independent insights, mentoring, discerning questioning and guidance for management.

We have highlighted this issue in our latest 2021 Stewardship Report using the example of MultiChoice, whose lack of independent directors forced some complex choices for shareholders, including ourselves. Here we explain our decision on MultiChoice and delve into our concerns around the independence of non-executive directors (NEDs) in South Africa.

MultiChoice: A lack of independent directors

MultiChoice was spun out of Naspers in March 2019, a transaction that happened relatively quickly and, in retrospect, without the amount of time necessary for it to put in place sound governance structures. This resulted in the rapid appointment of Board directors, particularly non-executive directors (NEDs), including a former executive as lead independent director (LID). This was not ideal, and the individual was replaced in April 2020. However, his successor unfortunately passed away in June 2021. This in turn resulted in the current LID appointment also being a former company executive, leaving this position “compromised” under sound governance guidelines. Together with the current Chairman of MultiChoice being a former CEO, this left governance at MultiChoice lead by NEDs with very close ties to management.

MultiChoice shareholders collectively have a dim view of governance at the company, demonstrated by the Board having failed in its remuneration vote with possibly one of the lowest levels of support seen on the JSE. Our stance against the 2021 remuneration vote was based partly on insufficient disclosure and an excessive fee arrangement with the current Chairman/ former CEO, who was paid R58 million in FY2021 and R17 million in FY2022 under a five-year restraint of trade agreement.

In our view, important governance fundamentals are clearly not yet in place at MultiChoice, making it very difficult to see the Board as being truly independent. This has been exacerbated by the complexity of the Chair and the CEO both residing in Dubai, a city with no corporate operations. These issues raise questions as to whether the Chair is not essentially remaining as an executive. With governance discussions ongoing into 2022, these developments resulted in extensive remuneration changes at the company.

We addressed these issues, along with other governance concerns, in formal correspondence to MultiChoice in late 2021, followed by meetings with Board in early 2022. While being one of their most outspoken critics on the lack of independence, we sought a compromise with the Board. This was after having received undertakings that new additional NED's would be appointed to balance the Board, and the LID would relinquish his position as LID (though not as a NED) within the next 24 months.

We also received sufficient information to temper our shorter-term governance concerns around the impact on the group's strategy. This, in our view, enables an appropriate transition to better governance, while leaving sufficient support for the executives in the interim.

Our compromise with Multichoice highlighted a complexity in the role of monitoring issues of true independence. Although it would be easy to oppose directors who are deemed not sufficiently independent, MultiChoice's NEDs do offer years of critical experience unique to both the company and the industry in which it operates, and have played a role in its ongoing success. Responsible investors must sometimes balance requirements of independence against taking actions that could harm shareholder value in the short term, deciding where exceptions to guiding principles can be made, and then closely monitoring them.

A scarcity of candidates

The most common explanation we hear from companies for nominating individuals with some type of connection to the company itself is a lack of suitable candidates in South Africa. Consequently, they say, NED's must be sourced from former company executives because their experience is very valuable. This is also the case when NED's remain on Boards for lengthy periods of time.

Most Boards will insist on some prior listed-company Board experience, or experience at a large sub-Board of a listed entity. This leaves few available NED candidates, and those that are

"The difficulty Boards face is that without proper due diligence of a candidate, an 'excellent voice' could simply be a well-resonating echo chamber of the rest of the Board. "

young and available may be "professional" NEDs, but they are likely to have never worked in any serious capacity on an operational level. We have reviewed many without genuine accounting, IT or ESG skills or background, or operational experience.

In fact, many have the sole experience of simply having been on other Boards. The reality, however, is that many professional 'Board sitters' often do not have the depth of expertise, or insights, into what management are facing as challenges, or ignoring as risks. As an example, one NED candidate we reviewed famously had attended over 100 meetings during the 2019 period, yet the Boards she sat on claimed she was an "excellent voice" in meetings.

The difficulty Boards face is that without proper due diligence of a candidate, an 'excellent voice' could simply be a well-resonating echo chamber of the rest of the Board. Behind the scenes, candidates for an NED's role need to be those who can genuinely question and guide management with critical thought and an experienced and "removed" perspective.

Due diligence?

When existing candidates are challenged by shareholders, the most common answer we receive is that the Boards themselves undertake a rigorous assessment of the individuals as a "selfcertification". This it is hardly appropriate for a company's most senior level of oversight on a personal level – there is a fairly evident conflict of interest if the candidate is well known to Board members.

And while some Boards are at least obtaining third-party due diligences of their members from outside companies, these entities can also be conflicted themselves; they are hardly incentivised to declare the Board members that hired them as needing removal.

The way forward

A potential, but not ideal, solution for some of the above concerns is for "experienced" hands to come onto Boards as non-executives, but for them not be classified as independent, and to ensure there are sufficient independent non-executive directors to counter them. Or better yet, to bring these qualified individuals in as consulting, but non-voting, invitees.

Specialised training for INEDs – supplementing that offered by the Institute of Directors where necessary – should also be offered to increase the talent pool in South Africa, and a limit set on the number of Boards an individual can belong to.

Some governance issues can also be resolved through better shareholder collaboration. South Africa has a sufficiently concentrated set of shareholders that, while ensuring regulations on change in control are not overstepped in law or in spirit, directors not meeting appropriate standards can be opposed through votes or collaborative engagement.

South African shareholders need to collaborate more frequently, question more deeply, and challenge more adequately. This should encompass not only resolving conflicts of interest and director independence issues, but also assisting in finding and pushing appropriately experienced and independent talent to Boards, and supporting these directors. And for those Boards where there are no obvious conflicts, but clearly best practice is not yet instituted, such as MultiChoice, it can simply mean requesting a transition to best practice in set time periods.

At M&G Investments, we have a long history of conducting strict due diligences on Board nominees, and our latest Stewardship Report relates some examples of our work in this area. We have made quite a few director appointments in past years with the support of other shareholders. The task of due diligence, stewardship and ensuring appropriate Board composition is an incredibly important function for shareholders, more so because some South African companies are falling short in these areas.

Anthony has been our liaison with the UN PRI since 2007 and played a leading role in drafting our Responsible Investment Policy and inaugural Stewardship Report. Anthony has taken on ESG as a full time role from early 2019, and is currently working out of the Governance Risk and Compliance department. His key areas are supporting or initiating engagements, legal and regulatory support for the investment team on corporate actions, and policy development. He has been in the financial services industry since 2003, having worked with Prudential since January 2007. Anthony's qualifications include Bachelor of Commerce and Post-Graduate Law degrees.

Sumayya Davenhill
Head of Marketing

Social investing in 2022: Education takes precedence

At M&G Investments Southern Africa, our social purpose is to empower individuals, and communities to enable inclusivity and socioeconomic equality. As long-term investors, we believe that success comes from lasting commitment and that true empowerment stems from more than just a donation; it requires consistency, dedication, and a willingness to make a difference over many years. Our country faces many social barriers, and if we are to make it better, not just for today, but for future generations, then what we do today needs to have the capability to empower into the future.

We believe that education lies at the heart of breaking the cycle of poverty in South Africa, and if we can sow the seeds for good education then surely generations to come will reap the rewards. Education empowers and is something that can never be taken away! It is because of this deep-rooted belief that educational investments are at the heart of our corporate social investment (CSI) programme.

> "We believe that education lies at the heart of breaking the cycle of poverty in South Africa... "

Nelson Mandela once said that education is the most powerful weapon to change the world. At M&G Investments, we have taken this to heart and put it into action by building strong and sustainable partnerships with organisations who share in this belief. We aim to help develop human talent, realise individual potential, and transfer practical skills to those young people in our communities most in need. We believe that by doing this, we will be helping to increase the number of previously disadvantaged individuals actively participating in the South African economy.

We are tremendously proud of our long-standing relationships with The LifeMatters Foundation, LEAP Science and Maths Schools, Fun Learning for Youth and SAME FOUNDATION. These organisations are passionate about educating our youth and providing the infrastructure and support systems necessary for that education; they share in our social purpose of doing good for today and for tomorrow.

LifeMatters: Supporting literacy and numeracy centres

Through our partnership with LifeMatters we have been able to build and support literacy centres in Westlake Primary and Sullivan Primary in Cape Town. Just this year, the team and volunteers at Life Matters have managed to complete 3,000 paired reading sessions with eager students. Growing and nurturing a love for reading has seen learners streaming through their lending libraries, and just over 4,000 library visits were counted across all beneficiary schools this year. M&G Investments has also invested to create and support a Numeracy Centre at Capricorn Primary in Cape Town. Mathematics skills are vitally important in the foundation years. The Numeracy Centre runs an intervention programme where students receive one-on-one sessions twice a week. The results from the numeracy intervention programme are quite remarkable, with participants improving from an average of 40.4% in November last year to 78.6% in June this year. We are extremely proud of these achievements and our partnership with LifeMatters. Congratulations must go to all the teachers and volunteers who clearly are empowering young minds.

LEAP: Boosting emotional development

In LEAP we have found a like-minded partner that makes a difference in transforming the lives of those that need it most. LEAP provides much-needed consciousness education that focuses on the systemic emotional and cognitive development of young minds, assisting them to have the necessary foundation so that they too can be the best that they can be. The goal is that these learners become economically active citizens who can do more than focus on day-to-day survival, but succeed in breaking the generational cycles of poverty. We have provided funding to three LEAP schools this year: Gauteng Alexandra, Diepsloot and Ga-Rankuwa. Each school has facilities to support the holistic development of the learner and focus on a learner-centred approach incorporating a variety of programmatic activities implemented as part of the consciousness education model.

The LEAP schools offer a full curriculum of subjects as per the national CAPs Curriculum. All schools have an extended school day (nine hours), Saturday classes and holiday programs with extra lessons in maths, science, and English. Students write the National Senior Certificate exams. In the 2021 exams, all the Gauteng schools achieved an incredible 100% pass rate. We are in awe of the dedication that the teachers have at these schools and at a recent Matric breakfast that we attended, it was evident that the matriculants from these schools are ready to take on the world and solve its challenges! We can't wait to see their success and its impact on our people and country.

Helping tertiary students FLY

Our partnership with Fun Learning for Youth (FLY) enables us to help students at a tertiary level. FLY provides students in need with bursaries and funding of textbooks and stationery, computers, student accommodation and living expenses, and all of these are made possible by the investments that we make here. FLY also has tutors that check in with students to help them with the challenges that come from tertiary education. Extra tuition is made available, and counselling is also offered to ensure that students stay on the path of success. At M&G Investments we believe that this investment will no doubt make a difference to these deserving students, and we may even make some dreams come true!

Rebuilding KZN schools with SAME Foundation

In Kwa Zulu Natal, the deadly effects of climate change resulted in severe flooding and landslides caused by heavy rainfall in April this year. Some 448 people lost their lives, over 40,000 people were displaced, and homes and schools were destroyed. We partnered with SAME Foundation to help rebuild schools where the infrastructure had been severely damaged. Additionally, we

donated much-needed new desks to Brettonwood High School in Umbilo in Kwa -Zulu Natal. This has not only made a difference to the physical classroom environment, but it has also had a positive impact on the learners' morale.

Industry and staff initiatives

As a long-standing member of the investment industry in South Africa, we are proud to play our part in government- and industry-related programmes that are aimed at improving equal education in our country. To this end, we contribute to the Ikusasa Student Financial Aid Programme (ISFAP) as well as the Fundisa savings fund. By partnering with industry and government we are playing our part in making the futures of many brighter.

Part of our social purpose centres around uplifting the communities in which we live and operate; we therefore extended our support to worthy causes that our staff are involved in. "Care and empathy" form part of our core values as a business, and we are supportive of staff who live this value, not only when they are at work but also when they are at home, in their communities. We are proud to have partnered with our staff to fund soup kitchens, old age homes, youth programmes and sports programmes.

Our staff have also given generously to our in-house CSI days. We had a very successful stationery drive for Youth Day with our beneficiaries' receiving boxes of much needed stationery. We celebrated our heritage by hosting a Heritage Day bring-and-share lunch. At a global level, M&G plc donated money for every plate of food brought in by staff and we matched their contribution, resulting in us being able to secure beds for five nights at The Haven Night Shelter for 347 homeless people on the streets of

Cape Town. On Women's Day we celebrated the strength of our female colleagues by contributing to the Saartjie Baartman Centre, who do phenomenal work helping abused women in our society.

"What counts in life is not the mere fact that we have lived. It is what difference we have made to the lives of others that will determine the significance of the life we lead".

— Nelson Mandela

At M&G Investments we are proud of these partnerships and the opportunities they provide for us to make a meaningful difference, but we also recognise that there is still much more to be done and we are committed to keep going for the long term, day after day.

Sumayya joined M&G Investments in 2012 and is currently the Head of Marketing and Retail Client Services. She is responsible for the M&G Investments brand, overseeing all of company's marketing and advertising activities as well as the retail client experience enabled by the retail Client Services Team. Sumayya also looks after the direct retail client's distribution strategy and is a member of the MandG Investment Managers (Pty) Ltd. Board. Prior to joining M&G Investments, Sumayya worked for Old Mutual Investment Group as the Head of Marketing where she was responsible for the full suite of investment companies within the Group. She has a wealth of advertising and marketing experience, having worked on brands such as Quaystone Asset Management and Nedbank earlier in her career. Her qualifications include an MBA (University of Cape Town) and a Post Graduate Marketing and Advertising Degree (Red & Yellow School).

Rahgib Davids
Equity Analyst

The travails of SA listed property in 2022

Key take-aways

- Concerns over rising inflation and interest rates, plus slow growth and loadshedding, drove listed property to record another year of underperformance in 2022, returning -3.6% year-to-date versus 6.0% from SA equities and 4% from SA bonds.
- Property companies with UK and European exposure fared worse than their more localised peers due to their higher starting valuations, which were sharply devalued amid the aggressive rate hikes.
- We have preferred companies owning diversified, SA-focused portfolios where rents are affordable, and with balance sheets strong enough to allow dividend payments and fund maintenance capex.
- Our stock picks led to outperformance of the M&G Property Fund versus the FTSE/JSE All Property Index for the year to 15 December, with a roughly flat return versus -4.0% for the benchmark – or 4% alpha.

We entered 2022 hopeful that listed property would enjoy a strong post-pandemic recovery as the world returned to normality, although there was lingering uncertainty about how the pandemic would structurally impact the demand for property (such as work from home, the acceleration of online retailing, and the onshoring of supply chains to avoid global blockages).

This optimism was largely overshadowed by a new wave of risks brought on by the Russian invasion of Ukraine in February and the war's far-reaching and protracted negative impacts. Concerns of high inflation, rising interest rates (and bond yields) and the possibility of a global recession overwhelmed an already-battered listed property sector and continued to do so for much of the year.

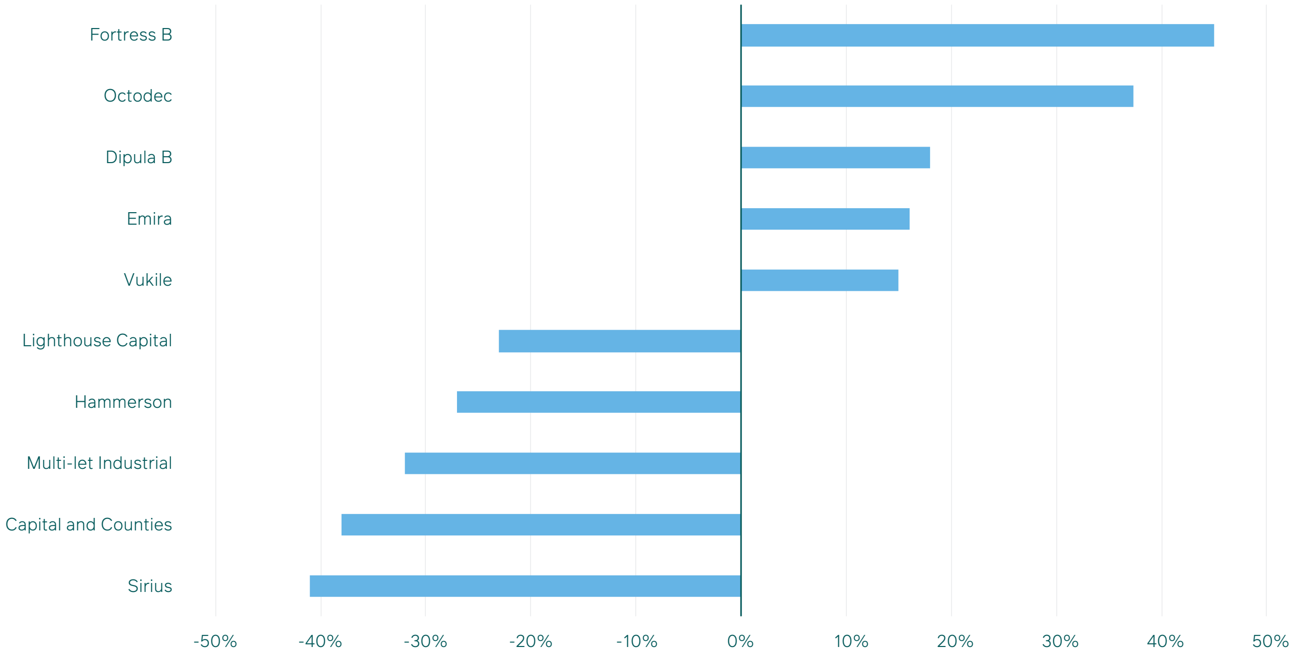
Graph 1: SA listed property underperforms equity and bonds in 2022

Source: Bloomberg, data as of 15 December 2022

As shown in Graph 1, market turmoil led to another year of underperformance. While equities and bonds delivered total returns of 6% and 3.7% respectively, listed property (represented by the FTSE/JSE All-Property Index) was down 3.6%. Despite the resumption of dividend payments that produced a 7% income yield, an 11% share price de-rating sent property into negative total returns.

Graph 2: Top and bottom property performances in 2022 (YTD)

Total return



Source: Bloomberg, data to 15 December 2022

Property is thought of as a homogenous asset class, but a look at the underlying property stocks (in Graph 2) shows a meaningful divergence in performance. There were clear winners and losers, reflecting the diversity within the SA listed sector that makes it a fertile ground for stock pickers looking to generate alpha for clients. The M&G Property Fund did well this year to produce roughly flat returns, outperforming its benchmark of the SA All-Property Index, which was down 4%. While luck played its part, we believe our robust investment process made us luckier by shaping our stock positioning to be defensive (avoiding losers) and opportunistic (owning some winners).

Picking winners

Our investment process is anchored on deep-dive, fundamental valuation-based analysis. Property companies are highly geared businesses, often carrying substantial levels of debt compared to their cash holdings, and so we spend a lot of time gaining comfort over balance sheet strength. This is overlayed with a broad understanding of market trends and supply-demand dynamics; we also leverage our dynamic valuation screening tools that allow us to spot opportunities as they arise.

At the start of 2022 our portfolios were broadly positioned for a general upturn in growth and markets, in line with the consensus outlook at the time. Our process led us to start the year with a bias toward high-yielding, deeply discounted, SA-focused mid-cap stocks, and an opposition to then low-yielding offshore stocks. Our preferred picks were SA Corporate, Dipula and Octodec, all of whom own diversified, SA-focused portfolios where rents are affordable, and have balance sheets strong enough to allow dividend payments and fund maintenance capex.

Dipula and Octodec were among the top performers in 2022, driven by starting valuations that were extremely depressed. When earnings expectations supporting their high yield materialised, we were paid a very handsome dividend yield. Octodec performed exceptionally well, re-rating 20% off the back of the demand prospects for their inner-city residential accommodation showing continued improvement, as people returned to Johannesburg and Tshwane for work and study.

Unfortunately, we missed the biggest winner, Fortress B shares. As we wrote in the Q3 2022 edition of Consider this, Fortress B has been subject to an ongoing battle with their A-shareholder counterparts over how the troubled dual-share structure will be collapsed. A shareholders have a preferential right to income as determined by the company's Memorandum of Incorporation (MOI); B shareholders get the residual income (if there is any). The big contention is around the ratio at which A shares will be swapped for B shares. With no progress toward resolution, it is difficult to offer a fundamental reason as to why Fortress B shares have done so well. As it stands, they are not entitled to any income and only have a right to a share in net asset value upon liquidation (which is unlikely to happen). Without a fundamental underpin, it's likely that the share price gains have largely been driven by speculation over a positive deal rather than anything of substance.

The losers

Sirius Real Estate, Capital and Counties, Hammerson, Multi-let Industrials REIT, and Lighthouse Capital were the biggest losers of 2022, producing losses of as much as -41%, as Graph 2 highlights. Their commonality is their exposure to UK and European property, which was hardest hit by the aggressive rise in inflation and interest rates from historically low levels. The UK/European listed property sector experienced drastic share price declines, reflecting market expectations that property values would fall. The mechanics behind these expectations can be understood from the following:

- The ultra-low interest rates of the past had the effect of indiscriminately inflating property values by allowing investors to buy property at low net income yields* (high prices) and still make a profit because their cost of debt was that much lower. However, with interest rates rising from 0% to 3% in such short space of time, investors now required a higher net income yield (lower property prices) to make those same deals profitable.

- Rising interest rates meant higher government bond yields, the risk-free rate component of discount rate used to value property. Higher discount rates resulted in lower property valuations.

Despite also suffering from rising inflation and interest rates, South African-focused property funds were relatively less impacted by these dynamics. That is because they are more accustomed to a high interest rate environment, with property values already reflecting high discount rates and share prices already trading at deep discounts to book value.

We believe the broad-brushed de-rating across the UK and Euro property sector is somewhat overdone, and we see opportunities in certain stocks we think will prove more resilient than what is implied by their depressed valuations.

*Net income yield = Net rental income/ Property value.

Two current opportunities:

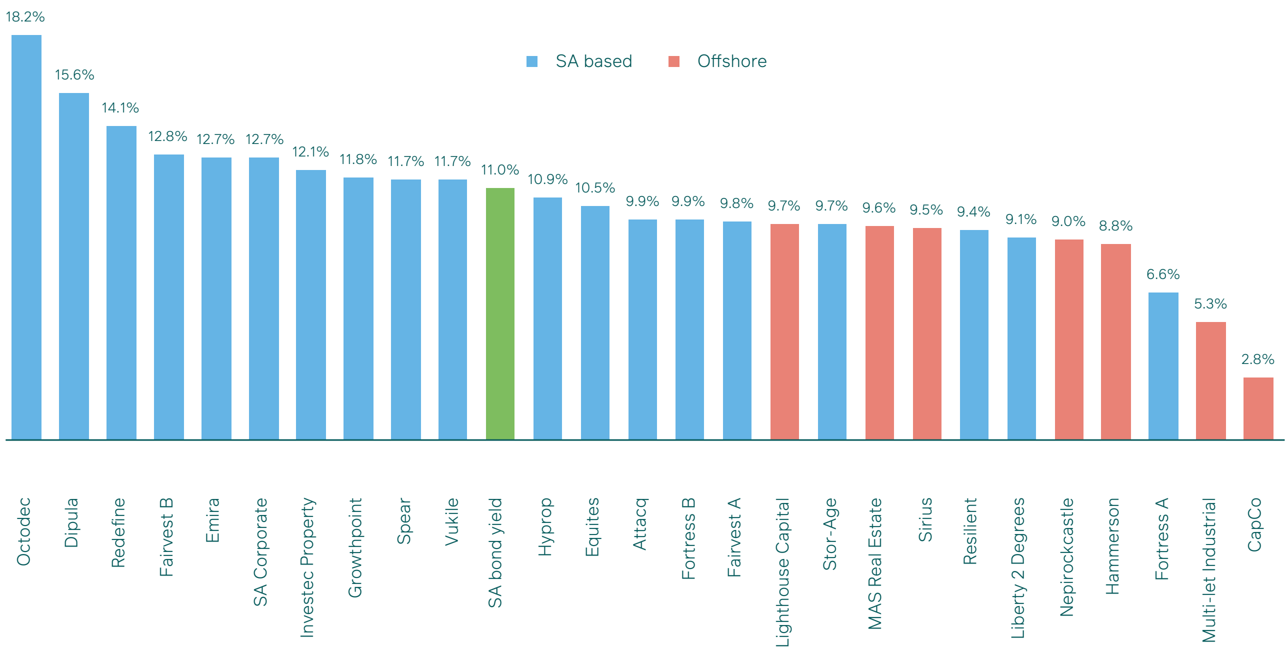
- Sirius Real Estate owns branded, mixed-use multi-let industrial parks across Germany and the UK. Their flexible short-term leasing model is advantageous in the current environment, allowing them to pass on inflationary increases in rentals and continue to grow earnings despite rising costs of debt. Their business model is driven by a robust leasing platform that facilitates active asset management and is a powerful marketing tool to attract new tenants. Management has an excellent operational track record and has consistently created value for shareholders. Following the fall in Sirius's valuation from a 1.8X price-to-book value ratio to 0.84X, we think the current share price offers an attractive entry point.

- Hammerson owns prime shopping centers in the UK, France and Ireland. Over the last five years, they have survived a retail property apocalypse that involved online retailers stealing market share, big department stores going bust and pandemic-induced lockdowns that debilitated operations. Property values and rental income were decimated, and desperate measures were implemented to stabilise the business, which included a rights issue and substantial asset disposals. The business is now stable and is backed by three large institutional shareholders that are actively in engaged in unlocking further value, that if successful, offers compelling upside from the current undemanding valuation.

Looking forward into 2023

We enter 2023 bearing the weight of uncertainty born in 2022. We don't know when inflation will ease and where interest rates will settle. In South Africa, the property sector is struggling with weak economic growth, high unemployment, and a deteriorating power supply that has been destructive for businesses. The office market remains oversupplied with corporates rationalising their space needs as they adapt to work-from-home policies. Retail property enjoyed a strong post-pandemic recovery in trade and is set to benefit from national retailers' ambitions to open new stores; however, severe consumer strain dampers the prospects for near-term rental growth.

Graph 3: SA listed property distributable income yields vs SA bonds



Source: Bloomberg, data as of 15 December 2022

Industrial property has outperformed, primarily due to logistics property where demand continues to be robust, driven by retailer optimisation of supply chains and a growing SA import sector.

In Graph 3 we can see there are 26 stocks to choose from in the SA listed property universe. For 2023, we prefer stocks that are best positioned to pass high inflation on to tenants, and thereby grow rents sufficiently to offset rising costs of debt. This includes stocks with exposure to:

- Central Eastern European retail where consumer spending is resilient; and
- Actively managed, flexible, short-term leases underpinned by affordable rents that offer near- term opportunities for repricing – this includes self-storage, multi-let industrial and residential.

Where inflationary growth is not possible, we retain our preference for high-yielding, mid-cap SA- focused stocks that offer a yield well above SA bonds (with the 10-year bond now around 11% as illustrated in Graph 3), compensating us for lack of growth. Lastly, we believe there is opportunity for substantial value unlock in deeply discounted offshore stocks and stocks facing special situations – such as Fortress A shares. With this positioning, we are looking forward to another year of alpha generation for our clients.

Rahgib joined M&G Investments as an Equity Analyst on 1 July 2020, and is responsible for select coverage of the Listed Property Sector. Prior to joining M&G Investments, Rahgib completed his CA(SA) articles at PwC before taking up a position at Kagiso Asset Managers as an Equity and Property Analyst. He currently has five years of industry experience. Rahgib holds an Honours Degree in Business Science and Accounting from UCT, a Post-Graduate Diploma in Accounting, and is also a qualified chartered accountant and CFA charterholder.

Analysis

iStock-1243578579

Clare Lindeque
Head of Quantitative Research

Investment risk through the Covid-19 crash

Key take-aways

- In contrast to a much-expected market recovery in early 2020, the Covid-related market crash caused the most severe disruptions to the SA equity and bond markets since the 2008 Great Financial Crisis (GFC). Global investment managers were caught by surprise.
- We increased the frequency of monitoring of our portfolio risk (tracking error). Our analysis showed it was market volatility, rather than our active positions, that was the primary source of the few brief breaches in our portfolio risk limits. We therefore did not need to reduce any positions to lower portfolio risk, avoiding selling in a down market.
- We were also able to buy up companies at excellent valuations, which provided the base for our portfolio outperformance in subsequent years.

The Covid-19 pandemic caused massive disruption to the world's economies, while leaving a trail of human destruction in its wake. It provided one of the clearest illustrations we've ever had of the notion that, although they are related, "the market is not the economy". Economic indicators took many months to return to pre-2020 levels, with the evidence of the pandemic etched on time-series charts forever more, but the stock market crash in response to the Covid pandemic was relatively short and sharp, with a drawn-out recovery. Here we take a look back at the worst period of the financial crash, how our markets reacted, and how we as investment managers handled the increased risk it brought to our portfolios. In retrospect, we can see that our processes worked well through an extremely difficult period in the market, while keeping our clients appropriately positioned to benefit from the recovery that followed.

Three things drive active investment risk: market volatility, correlations between assets in the market, and the active exposures held in a portfolio. As active managers, we have control of only one of those to help manage investment risk for our clients: our exposures. So, what happened in the first half of 2020, and what were we exposed to?

Positioned for a 2020 upturn

Let's start with the portfolio positioning. Apart from a few concerned virologists, the world entered 2020 blissfully unaware of the economic and social disruption that was to unfold. The IMF's World Economic Outlook report for January 2020 spoke of modest increases to global growth for the year, accompanied by improving market sentiment, with concerns about geopolitical tensions, the trade war between the US and China, and weather-related disasters. Our portfolio positioning and thinking in early 2020 reflected the moderately bullish global sentiment, with cautious optimism on SA equities and bonds.

Given this backdrop, M&G Investments' portfolios were therefore broadly positioned for an upturn. Our multi-asset funds were long risk assets: they were overweight foreign equities and SA nominal bonds, and depending on the mandate type, some were slightly overweight SA equities as well. Owing to the negative yields on offer in the UK, EU and Japan, we were underweight global sovereign bonds (historically providing a cushion during market crises) but holding some investment grade US and EU corporate bonds.

Our general equity portfolios were overweight SA Banks, Personal Goods (Richemont), Tobacco, Media, General Financials and Chemicals. Crucially (both in a positive and negative sense), we were underweight food and drug retailers, health care and life insurance.

Our equity style positioning was heavily tilted towards stocks we judged to be offering attractive valuations (this is usual, given our investment approach), as well as high beta stocks (or those whose performance amplifies that of the market. The portfolios were tilted away from low volatility and low beta stocks, and without much of the protection that a high-quality tilt would provide during a market crisis.

For both SA nominal and inflation-linked bonds (IBs), our funds were long duration relative to their benchmarks, with overweight positions in bonds with maturities longer than twelve years.

Then came the crash.

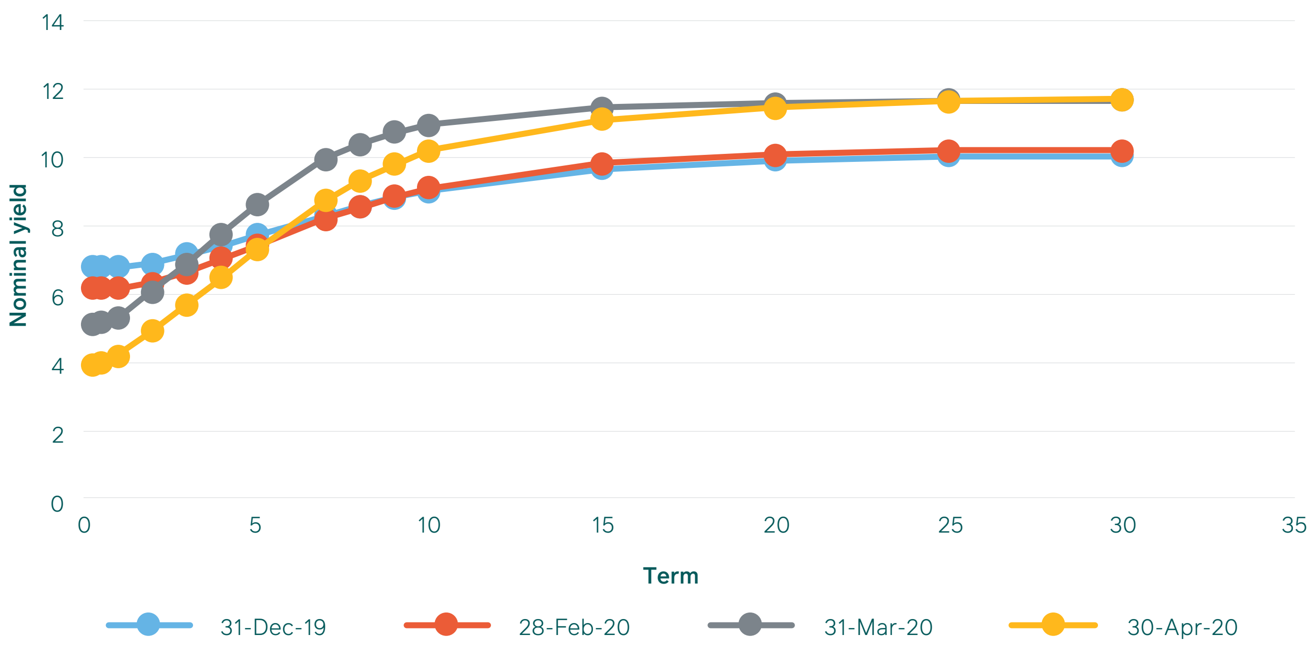
Riding out the crash

While we felt somewhat isolated in South Africa from what the Northern hemisphere was grappling with in late January and early February, an increasingly clear picture was emerging: the Chinese government was having to engage herculean measures to stem the spread of the virus, while infected travellers were fanning out across Europe and the Americas. As February progressed, it became apparent that northern Italy had a serious problem, and outbreaks in Iran and South Korea were also progressing apace. On 24 February, the markets finally decided that the impact of an epidemic that extended beyond Asia to the whole world, would be devastating. Over the month that followed, governments across the world issued stay-at-home orders, including South Africa, which shut down on 27 March.

From a South African investment perspective, the Covid crash presented some of the worst short-term equity returns (over all horizons less than one month) that we've ever seen. This was also the case for nominal and inflation-linked bonds. Graph 1 shows how the nominal bond yield curve steepened sharply between January and April, with a fall in short-term interest rates and a

Graph 1: SA yield curve steepens sharply

SA nominal bond yields at different dates (Jan-April 2020)

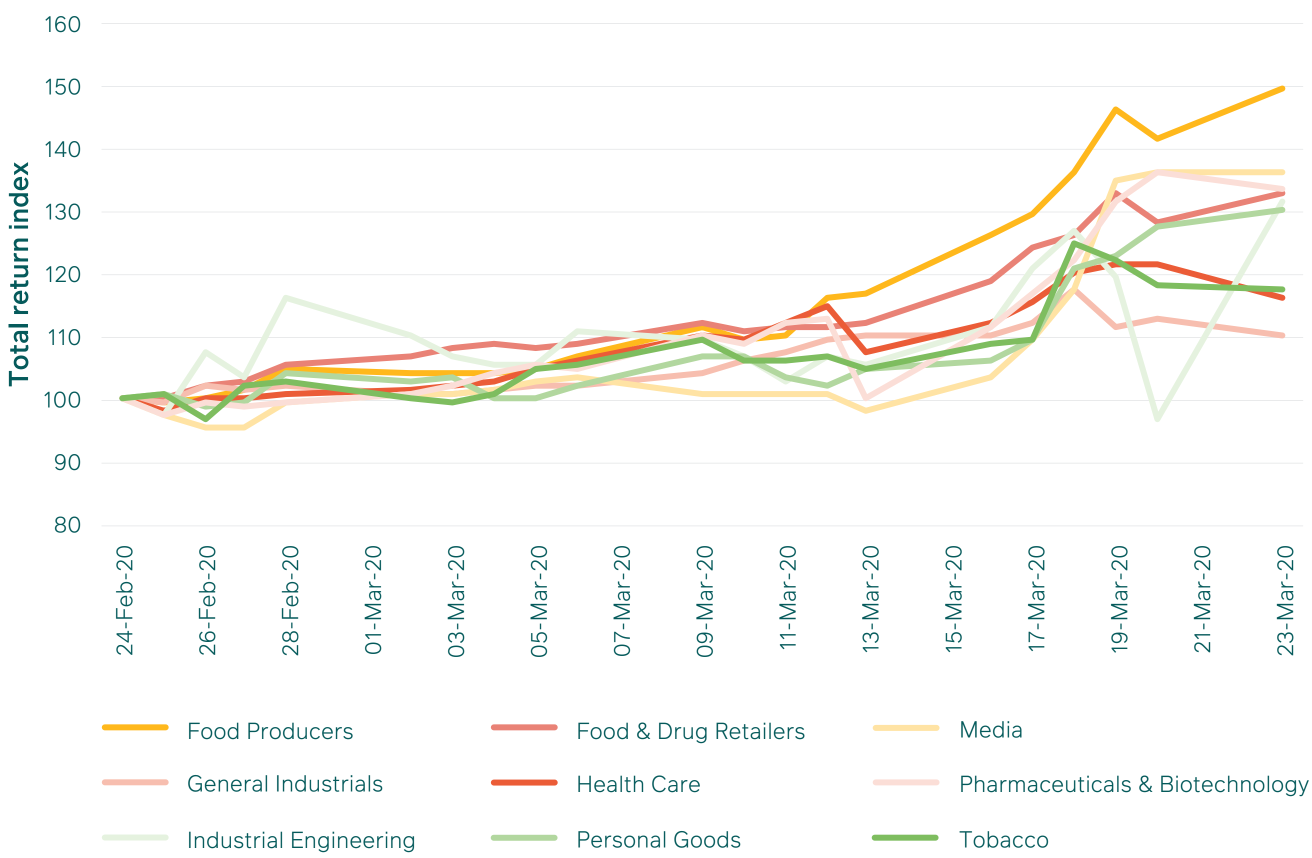


Source: Bloomberg

rise in longer-term rates – real 10-year yields peaked at over 6% (compared to their historic average of around 3%). Plus, bond yields took longer to normalise than equity performance, and we noted increased market volatility and lower new bond issuance for the rest of 2020 and well into 2021.

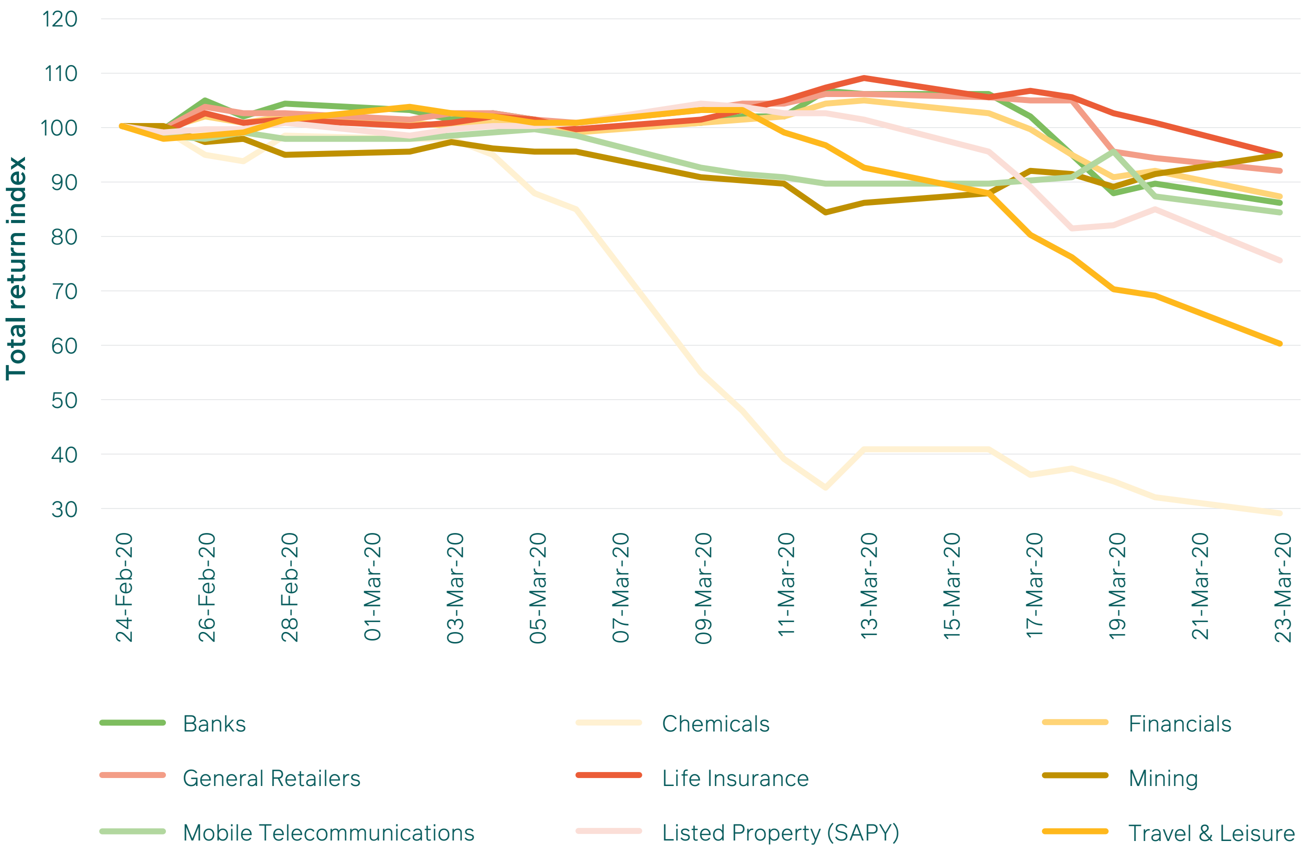
Although we are still even now experiencing the economic impacts of Covid in many parts of the world, global financial markets began to recover just a month after the initial crash, when it became clear that the Federal Reserve and other central banks would do "whatever it takes" to limit job losses and promote a recovery.

Graph 2: Outperforming equity sectors during Covid crash



Source: Refinitiv

Graph 3: Underperforming equity sectors during Covid crash



Source: Refinitiv

The South African equity market, which had fallen 37% (FTSE/JSE Capped SWIX Index) from its 1 January 2020 value, also began to recover. The recovery was slow and uneven, however, and it was only towards the end of 2020 that the market returned to the levels it had attained at the end of 2019. Graphs 2 and 3 highlight the outperforming and underperforming sectors over the February-March period. Note that our portfolios were overweight sectors shown in shades of green, and underweight those coloured orange-yellow-red.

The graphs show SA equity sectors' performance during the worst of the crisis. Defensive sectors less impacted by the shutdown fared the best, like Food Producers, Food and Drug Retailers, Tobacco and Health Care. The worst-performing sectors included Chemicals (which incorporates Sasol's fuel production businesses), Travel and Leisure, Listed Property and Banks.

Our portfolios were helped by our overweights in Tobacco and Personal Goods, but hindered by our Health Care and Food Producers underweights. Our Chemicals overweight (Sasol) fell dramatically as the demand for fuel declined amid travel restrictions and slower economic activity, but we benefited slightly from our Life Insurance and General Retail underweights.

On the style front, our strong value exposure was a detractor from our equity performance, as was our underweight to low volatility stocks and quality, and our high beta overweight.

In bonds, our overweight to the long end of both the real and nominal yield curves led our fixed income funds to struggle through much of 2020, as the yield curve underwent more dramatic moves in a single quarter than most fixed income managers have seen in their lifetimes. However, our fixed income funds saw a strong recovery in 2021 and have continued to generate excellent returns through 2022. The same was largely true for our multi-asset fund performance, given our equity and bond positioning.

Risk management and the Covid crisis at M&G Investments

Our risk management process exists to manage the third – controllable – element of portfolio risk noted above: active asset exposure. All our portfolios are run with risk limits in mind: we measure these using tracking error for equity and multi-asset portfolios, and duration limits (absolute or relative) for our fixed income portfolios. Duration takes into account a bond's (or bond portfolio's) overall maturity, yield, coupon and call features to determine its interest rate risk, or how sensitive its value is to interest rate changes. Generally, longer-dated bonds have higher duration, and therefore present higher risk to investment portfolios.

These risk limits are either agreed with segregated clients as part of the investment management agreement, or for our unit trusts, they are set internally with reference to the portfolio's expected risk characteristics, required returns and investment strategy. We closely monitor all our portfolios to ensure they stay within these specified limits.

During the height of the Covid crisis, we increased the frequency of risk monitoring and reporting to the investment team. For the multi-asset funds, we performed scenario analysis to understand how our risk was split between stock selection and asset allocation risk. We did this by constructing multiple "paper portfolios" which each isolated one aspect of the portfolio's construction at a time, splitting out the asset allocation decision for each asset class, from the security selection within an asset class.

We noted sharp increases in tracking error during March 2020, but were able to see that about two- thirds of this came from increased market volatility, with the remainder from earlier changes to our active positioning since the end of December 2019. This gave us confidence that the tracking error increases would only be transitory, and therefore when we experienced breaches of the risk limits by a handful of portfolios, we were able to wait out the short period it took for the active risk to come back down to acceptable levels.

In one breach, for example, strong divergences in equity performance across the globe meant that, briefly, our 14% holding of the M&G Global Equity Fund in the Dividend Maximiser Fund (where the fund gets its offshore equity exposure) was contributing nearly 40% of the portfolio's active risk. This situation normalised of its own accord over the following months

Consequently, we did not have to de-risk any portfolios by selling certain assets to conform to risk limits. This was a very positive development because, during a crisis, tremendous opportunities arise for active managers, and asking them to move to cash or sell out of underperforming (and often very cheap) positions is likely to lock in losses and destroy value. Instead, our equity team was able to take advantage of excellent opportunities at the bottom of the market; similarly, divergences in asset class valuations meant that the multi-asset team was, for example, able to snap up inflation-linked bonds at some of the cheapest valuations ever seen.

An investment risk process is – by its nature – usually countercyclical, calling for decreases in risk in portfolios at exactly the wrong time. Awareness of this tension, combined with well-set risk limits, timely data, understanding of risk sources, patience, and established risk reporting, not to mention our prudent portfolio construction processes, carried us through the Covid crisis and into the recovery. There, the moderately bullish positioning with which we'd entered 2020 was able to generate alpha over subsequent periods. □

For more information:

1. https://www.mandg.co.za/insights/articlesreleases/market-observations-q4-2019/

2. https://www.imf.org/en/Publications/WEO/Issues/2020/01/20/weo-update-january2020

For a cogent economic history of the Covid crisis, Adam Tooze's book "Shutdown" cannot be recommended highly enough. Tooze is one of the premier economic historians of our time and has managed to achieve sufficient distance from his subject to present an ordered account of a period that, for most market participants, was a blur of activity and rapid news flow.

Clare Lindeque is Head of Quantitative Analysis at M&G Investments. She and her team provide analytics that are used as an adjunct to the fundamental part of the investment process, and she is also responsible for market risk analysis and reporting to the investment team. Clare has a M.Sc. in Financial Mathematics from the University of Cape Town, the Financial Risk Manager (FRM) qualification from GARP and is a CFA charterholder.

Opinion

iStock-1269951769

Kerry Horsley
Head of Governance, Risk and Compliance

Reflections on three decades of financial regulations

Key take-aways

- South Africa has made significant strides in safeguarding individual investor welfare through legislation and regulation involving worker representation on pension fund boards, client reporting standards, detecting financial crime, data protection, needs-based selling, etc... that many individuals may be unaware of.
- Our investment industry is world-class, but more needs to be done in terms of investor education, pro-active investigation of criminal financial transactions, differing interpretations of standards, and closer surveillance of insider trading and market manipulation, among others.
- Information verification has proved to be cumbersome and an additional barrier to investing,

In a few months, I will be taking a break from financial services so that I can follow an old dream of going back to full-time study for several years. I am doing this in consultation with M&G's leadership, and we have spent the last few months making sure that I fully hand over my responsibilities in a steady and structured way. In truth, the compliance team I have been working with for the last decade and more has been doing the "heavy lifting" for some time now, and my move is a natural progression. As soon as we have the necessary regulatory approvals, we will introduce them and their new roles.

With the decision made to follow a new path and the practical considerations in my function taken care of, I find myself reflecting on a career of 30 years in financial services. And because change and reflection of this nature makes most of us (or maybe it's just me?) quite self-involved, I find myself wanting to share some of these reflections.

Better trustee training, but what about fund members?

When I first started, the industry was engaged with significant proposed changes to the Pension Funds Act – specifically the requirement to include member-elected representatives on the management boards. I like thinking about this time because it reminds me how significant it felt then and how natural and obvious it feels now: of course members should have representation on their retirement funds. Of course the pension fund is exclusively theirs, and one of the most crucial building blocks in saving for old age and emergencies.

As a result, in these early days we were extremely busy with trustee training programmes and a cottage industry quickly followed. And right there, a side benefit of the regulatory change appeared – knowledge sharing and empowerment. Would it not be fabulous if the same could be said for investor education programmes? Why are there still exceptionally smart, engaged, curious investors running their lives, their businesses and their careers who still glaze over when the topic turns to financial products? Why is investing still a grudge purchase? Why are our investors still intimidated by our products and how they actually work? After all, if I can understand derivatives, anyone can.

Financial crime detection still falling short, despite the paperwork

The next big regulatory change introduced from the late '90s was the suite of financial crime legislation starting with regulating organised crime and ending with codifying the obligations to prevent money laundering. This has been a significant change in our industry and is, to my mind, a constant source of friction. At a theoretical level, the rationale for this legislation is obvious. Why would we want our financial services industry to become a haven for criminals and crime and a global pariah? At a practical level, oh my goodness, if financial products are already a grudge purchase, the process of proving we are who we say we are, and that our hard-earned money is actually legitimate, is overwhelming. From my perspective as both the functionary implementing the legislation and as a financial services client, I feel this tension all the time.

As far as we have come in adapting to this anti-money laundering regime, I do believe that we have not yet climbed this mountain. It still feels like our efforts are merely responsive and not pro-active detective work – as sharply evidenced during the days of state capture. My perspective is clearly from the outside of the state's detective and enforcement agencies, however, and I claim no special expertise or knowledge on this subject.

Some murky areas remain within FAIS

Around the same time as the financial crimes legislation (because waves never arrive on their own), we saw the omnibus FAIS (Financial Advisory and Intermediary Services) legislation that tried to regulate market conduct regardless of the type of company performing financial services. This legislation, from my perspective, aims to put our clients at the centre of what we do. It has pushed consumer protection, data protection, needs-based selling, honesty, integrity and clarity in our marketing and selling, among other best practices. We in the business probably all thought we were already doing this, so perhaps it’s better to say that the legislation defines how we should evidence this practice.

I wasn’t intimidated by the legislation. Much of it was extremely familiar and almost borrowed wholesale from existing asset management legislation. What has been a struggle are the few round pegs squeezing into square holes. This has mostly been in the area of advice-giving, where the institutional client and retail client processes don’t easily align in terms of what clients need versus what is required. And, of course, the areas of managing conflicts of interest in asset management (trading processes; deal allocations; personal account trading; etc.) and sales practices (what is allowable for client entertainment; conferencing; charity events; etc.) remain frustratingly debatable given the widely different interpretations across the industry.

Self-regulation prevails, but market still vulnerable to abuses

I have one final regulatory reflection. When I started in asset management, I was picking the brain of one of the “grey hairs” I have always sought out – their stories are the best and their egos are not or no longer inflamed. He related that when he started as a young analyst, he and his colleagues were lobbying for salary reviews. His leadership responded with: you’re in possession of all the information you need to make your own salary. What leadership was talking about was access to market analyses and data as well as client trade and investment data. Oh, the “wild west” of investing indeed. That was when, as another grey hair described it, insider trading was a national sport.

Not terribly much has changed regarding insider trading and market manipulation legislation since the early 2000’s, but my experience is that much has evolved in our practices. While the threat of prosecution is indeed scary, the reputational risk in our tiny industry is, to my mind, the biggest deterrent. What I find heartening is that the industry embraced the challenge collectively. Asset management is a value chain from stockbroker research to investment analysis and decision to trade and back to stockbroker execution and settlement. By its very nature, this value chain requires collusion between parties if anyone in that chain is intending to trade in inside information or manipulate the market. It is my view that this separation of function has meant that, in recent years, incidents of insider trading and market manipulation on a mass scale have been hard to find. And because asset management is a competitive game, watch the hackles go up if we suspect someone else of trying to cheat the system! Talk about self-regulation. From my perspective, and it’s a humble one, there are gaps in the legislation – some pretty big ones. Market manipulation is notoriously difficult to regulate. Its success is a collective effort.

What I take from this brief review of the big changes in our legislative landscape is that there have been great strides in keeping investors and our broader financial system safe and strong amid rapid globalisation, expanding product choice and technological progress. Our financial system remains among the strongest in the world. I'm proud to have played a part in this and to have seen many more South Africans brought into the world of investing. In a country with an extremely fragile social security net, an investment culture and practice are absolutely critical to individual work-life standards of living and, crucially, to post-work-life dignity and security.

However, we have seen, especially in the last ten years, what the limitations of legislation are when there is a concerted and coordinated effort to undermine the rule of law. Lurching over the horizon is a new wave of financial services legislation but, as this has been a retrospective, I will leave the future of our legislation to others. I'm confident that my fellow compliance colleagues and successors are well-equipped to meet this. □

Kerry joined M&G Investments in 2010 as Head of Risk and Compliance. She is responsible for governance, which includes: regulatory compliance; operational risk management; the legal function; control insurance and responsible investment. She is a member of M&G Investments' Executive Committee and Investment Risk Management Committee as well as a permanent attendee for all Board meetings and Board Subcommittee meetings. Prior to joining M&G Investments, Kerry served as Head of Compliance at Old Mutual Investment Group. With 24 years' investment experience, Kerry has worked for various financial services providers in a range of compliance and risk management roles. Kerry's qualifications include: BA, University of KwaZulu-Natal; LLB, University of Kwa-Zulu-Natal; LLM (Distinction), University of Cape Town.

Aadil Omar
Head of Equity Research

Planck versus the Chauffeur: An illustration of rote vs. applied knowledge

Key take-aways

- In investing, like in any profession, rote or superficial knowledge cannot be applied to create an outstanding result or performance; professional results come from true understanding and experience.
- Only with a deep understanding beyond memorising the basic facts can one exercise appropriate judgement in new circumstances and produce a successful outcome in investing.
- Deep understanding gained through study and practice over time can prepare you for the unexpected.

Below are two questions we put forward to a market participant who has been well trained. After reading the responses, I invite you, dear reader, to have a guess as to who the responses might have come from.

Question 1: How do I beat the market?

Response:
Beating the market is a difficult task, and there is no sure-fire way to achieve it. However, there are some strategies that can increase your chances of success. These strategies include:

1. *Diversify your investments: By investing in a variety of different assets, such as stocks, bonds, and real estate, you can reduce your overall risk and increase the likelihood of achieving strong returns.*

2. *Rebalance your portfolio regularly: Over time, the value of your assets will change, and some may perform better or worse than others. By periodically rebalancing your portfolio, you can ensure that your investments are aligned with your goals and risk tolerance.*

3. *Stay informed: By keeping up with the latest news and developments in the financial world, you can make more informed decisions about where to invest your money. This can help you identify opportunities and avoid potential pitfalls.*

4. *Follow a disciplined approach: It is important to have a plan and stick to it. This means setting clear investment goals, establishing a diversified portfolio, and regularly reviewing and rebalancing your investments.*

By following these strategies and staying disciplined, you can increase your chances of beating the market and achieving your financial goals. However, it is important to remember that there are no guarantees in the stock market, and investing always carries some level of risk.

Question 2: Why do most investors fail to beat to the market?

Response:
There are several reasons why most investors fail to beat the market. One reason is that the market is generally efficient, which means that most publicly available information is already factored into the prices of securities. This means that it is difficult for investors to consistently find mispriced securities that they can profit from. Additionally, the fees and expenses associated with buying and

selling securities can eat into investors' returns. Finally, many investors make emotional decisions that are not based on sound investment principles, which can lead to poor performance.

I'm sure you found both responses quite reasonable, if not slightly casual. Perhaps you guessed that the interview was conducted with a financial journalist or market commentator. At a stretch, you may assume these are the words of a conservative unit trust fund manager.

You may be surprised (and impressed) to learn that these responses were generated entirely by CHATGPT[1], a natural language processing engine (see more details below in CHATGPTs "own words"). At the risk of stating the obvious, the above responses have no human input.

At face value, the responses are informative and well-articulated, the ideas are cogent and flow logically, and you may also say that the questions have been adequately answered. But here's the thing – in as much as CHATGPT has been able to render in plain speech these broad generalisations, it has neglected the nuances necessary for market-beating returns. The responses are lacking the insight on the true nature of active investing and risk management. Viewed in this light, one could stay that CHATGPT is exquisite at reproducing information efficiently, but it is not designed to exercise judgement on things that are not just matter of fact.

[1]CHATGPT is a natural language generation model developed by OpenAI. It is a variant of the GPT-3 (Generative Pretrained Transformer 3) model, which has been trained on a large amount of text data to produce human-like text. CHATGPT is specifically designed for conversational text, so it can generate responses to text inputs in a way that resembles a human conversation.

Planck versus the Chauffer

Well-known investor Charlie Munger has often told the story of Max Planck, the Nobel Prize-winning physicist, and his chauffer on tour through Germany. It goes as follows: *Max Planck went on a tour where he delivered the same lecture on new quantum mechanics across several German cities and towns. Over time, his chauffeur committed the lecture to memory, and at one point ventured: "It has to be boring giving the same speech each time, Professor Planck. How about I do it for you in Munich? You can sit in the front row and wear my chauffeur's cap. That'd give us both a bit of variety." Planck liked the idea, so that evening the driver held a long lecture on quantum mechanics in front of a distinguished audience. Later, a physics professor stood up with a question. In response, the driver recoiled: "Never would I have thought that someone from such an advanced city as Munich would ask such a simple question. My chauffeur will answer it!"*

Charlie Munger uses this story to illustrate two types of knowledge:

1) *Planck knowledge:* Representing a true understanding of subject matter from which one can draw insights, exercise judgements and act in a way suitable to the circumstances.

2) *Chauffer knowledge:* A superficial rote understanding lending to a regurgitation of content. Most useful in descriptive application.

As is evident from the story, chauffer knowledge is useful in description and conveyance, but inadequate when that knowledge must be applied. Understanding is an exercise of application – and we know it when we see it.

Performance is knowledge made manifest

Watching a performer at the top of their game, say a prima ballerina in Swan Lake or Lionel Messi at the 2022 World Cup, is awe-inspiring. We know the performance is rooted in something deeper than mere familiarity – an underlying intimacy with the game such that it becomes tricky to tell the performance from the performer.

Performance arts are intriguing to us as observers, yet how exactly these people do what they do is often lost in translation. Any descriptions appear clumsy or simple, and forced into abstract deductions. This is probably the best self-account for the “performer” way to reference all the nuances and subtleties required in world-class performance.

While knowledge-based activities are less abstract, there is a fair amount of nuance and circumstantial understanding that is also lost in translation. Investing is one such activity. Even if you have the full working manual of the best investors out there, the application of their process is often person- and team-specific and does not travel easily. That’s why Warren Buffett can tell you exactly what he does without being concerned you might pop up a competing business nearby.

“What I do is play soccer,
which is what I like”

— Lionel Messi

Knowledge prepares you for the things you did not prepare for

It must be said that I have nothing against chauffeurs, and I think that CHATGPT is one of the most incredible tools I've used in 2022. Nevertheless, the events of the last few years in which we witnessed a global pandemic and associated lockdowns, the Russian invasion of Ukraine and the emergence of inflation the likes of which hasn't been seen in four decades, have made it abundantly clear that the world is a downright unpredictable place. Reliance on easily digestible answers and simple (though thorough) playbooks would not have been adequate in navigating the undulating nature of reality. Nevertheless, M&G Investments has fared quite well in this rather unconventional time, and although I cannot provide you with an exhaustive description of exactly how and what we have done, I can remind you of a few key tenets we've observed during this time, and at all times:

- Adhere to a trusted and time-tested process;
- Avoid the risk that might lead to ruin, no matter how small the probability; and
- Focus on those things that are in our circle of competence.

We cannot know all there is to know and we certainly cannot tell the future; like Lionel Messi, all we can do is play our game. □

Aadil joined M&G Investments in July 2013 as an Equity Analyst. In August 2018 he joined a global equity hedge fund in London, before returning to M&G Investments in January 2020 as Head of Equity Research. With 15 years' investment experience, Aadil's qualifications include a BCom degree (Hons, cum laude) from the University of Pretoria and a Masters in Finance degree from INSEAD. He is also a CFA charterholder.

Janneke van Rooyen
Quantitative Analyst

The father of fractals dissects financial market moves

The (Mis)behaviour of Markets: A Fractal View of Financial Turbulence was published in 2004 and written by the late Benoit Mandelbrot and Richard L. Hudson. Mandelbrot was a renowned mathematician often referred to as "the father of fractals", and the book is written in his voice. He has a long list of accolades, and even an asteroid (diameter 11km) was named in his honour, the 27500 Mandelbrot. Hudson, meanwhile, is a journalist and currently editorial director at Sience|Business.

The book comprises of three parts: *The old way, The new way* and *The way ahead*.

In *Part I: The old way,* Mandelbrot warns that we have been mis-measuring risk in financial markets. He describes the different states of randomness as mild and wild. Mild randomness occurs in the world of normal (or Gaussian) distributions, described by the familiar bell curve, where big changes are the result of many small ones. Wild randomness occurs in a world described by the less-familiar Cauchy distribution, where major events "loom disproportionately large". He explains the differences between these distributions by comparing two games of chance, the mild and simple coin-toss vs the wild blindfolded archer shooting at a target on an infinitely long wall, where the distance of the miss determines the score. In the Cauchy distribution a single miss can easily be the size of all the other misses combined.

Mandelbrot dedicates a chapter to Louis Bachelier, the first person to apply the concept of Brownian motion, a stochastic process used in physics to describe the way heat spreads, to modelling price changes. Within the assumption that price changes follow a Brownian motion lies a subset of critical assumptions, including that each change in price is independent from the previous prices in a series of prices (thus a price has no 'memory' of previous prices), as well as that price changes follow a normal distribution.

He then follows the use of Bachelier's theories through the 20th century by Markowitz, Sharpe, Black and Scholes, some of the greatest influencers in financial market theory. In the concluding chapter of *Part I, The Case against the modern theory of finance*, he dissects four assumptions underpinning the theory of finance, and illustrates how they differ to reality. These are: people are rational and aim only to get rich; all investors are alike; price change is practically continuous; and price changes follow a Brownian motion. This book was written in 2004, so many models have been adjusted and new models created to move away from these assumptions.

"A fractal is a pattern or shape whose parts echo the whole, only scaled down."

In *Part II: The new way*, Mandelbrot develops a Multifractal Model of Asset Returns. This section is written as if he is a detective stumbling on clues, where each clue is a mathematical tool from a different field or from a different age. He introduces the concept of long memory, and shows how using a similar approach as Brownian motion but using what he calls the Hurst factor, to create a price series that has some form of memory (i.e. not independent). He also introduces the concept of multi-fractal time. The chapters in this section are quite technical, but his explanations are clear – he often adds relatable comparisons in his explanations. Chapter 8, the mystery of cotton stood out to me.

The mystery of Cotton tells the story of how Mandelbrot came to notice a fractal pattern in a large set of cotton price data. This chapter gets quite technical, but to summarize, Mandelbrot plotted the frequency and the size of cotton price changes on a log-log scale. From here he observed that the size of price changes consisted of many small moves and a few, very large jumps, not as scary as a Cauchy distribution, but a lot less tame than the normal distribution. He then creates the same plot using different time periods and scales – and these all look the same – there is a fractal pattern in the cotton data.

In *Part III: The way ahead* Mandelbrot lists what he calls the 10 heresies of finance. These are to him, obvious facts that often contradict received wisdom. Some of the more controversial include:

- Market "timing" matters greatly. Big gains and losses concentrate into small packages of time.

- Markets in all Places and ages work alike.

For the final chapter, *In the Lab*, he lists areas where he believes fractals can be of use in finance.

I would highly recommend this book to anyone interested in financial markets and/or fractals. The style is light; Mandelbrot himself describes the book as pop science. He includes many images that provide a visual aid to concepts. The fractal gallery – a set of images of famous fractals included in Part II – was quite a treat, especially the very dramatic 1893 quote from Charles

Hermite, a French mathematician, when he is introduced to the Koch curve: “turning away in fear and horror from this lamentable plague of functions with no derivatives”. It is key to keep in mind that this book was written in 2004, so some of the critique will be outdated.

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