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Ninety One

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Investing for a world of change

Drivers of return in an interest rate-hiking cycle

Paul Hutchinson
Sales Manager

The fast view

- Quoted fixed income rates often differ (simple versus compound). Be sure to compare like-for-like, as the impact can be material.
- In a rate-hiking cycle, cash yield (as offered by a fixed deposit) does not need to be your only source of return in a flexible fixed income fund.
- In the most recent rate-hiking cycle (2014-16), Ninety One Diversified Income Fund outperformed a 3-year fixed deposit 90% of the time, on average by 0.2% p.a., with the additional benefit of daily liquidity.
- Over the long term (through the cycle), Ninety One Diversified Income Fund has participated meaningfully in bond market rallies, and protected the portfolio in sell-offs, delivering investors a 1.1% p.a. return above cash net of fees over the long term.

The rising interest rate environment is making fixed deposits optically more attractive. Unfortunately, things are not always what they seem. Therefore, it is important to be careful when comparing quoted interest rates. This is because, in many cases, fixed deposits are quoted as 'interest to maturity', which is a euphemism for a simple interest rate. This differs from the standard yield-quoting convention of fixed income securities, which are usually quoted as nominal annual compounded semi-annual rates (NACS).

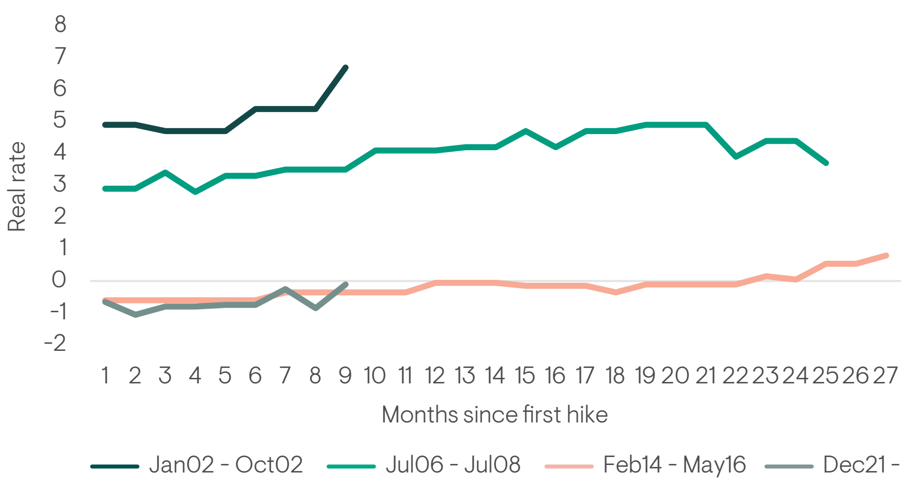
To give you a sense of how different these rates can be, a 3-year fixed deposit, which is currently quoted with an 'interest to maturity' of approximately 9.7% has the equivalent NACS yield of 8.7%; a difference of 1%. In fact, when converting this simple interest rate into its NACS equivalent the average difference over time has equated to around 100 basis points. This means that when looking at 3-year fixed deposit rates, you can typically subtract up to 1% from the quoted yield before comparing it to the yield offered by other fixed income securities!

Yield is not the be-all and end-all

Importantly, in a rate-hiking cycle, as we are currently experiencing, cash yield does not need to be your only source of return.

The following chart illustrates the real interest rate path of each hiking cycle in the past 20 years (2002, 2006 – 2008, 2014 – 2016, and the current cycle, starting in 2021). In our search for learnings from these previous hiking cycles, we found that the 2014 – 2016 cycle most closely represents the current cycle. This is because both now and in 2014, the starting real rate (being the current repo rate minus future inflation expectations) is/was negative.

Figure 1: The path of real interest rates in previous rate-hiking cycles



Source: Bloomberg, Haver & Ninety One, August 2022.

We also noted that the difference in interest rates (often referred to as the spread) between 3-month cash and 3-year fixed deposits was at their widest at the beginning of each hiking cycle. This spread then typically narrowed/tightened as short-term cash interest rates priced in the subsequent increases in the repo rate, with the result that subsequent 3-year annualised cash returns typically outperformed their starting yields by approximately 1% p.a. in a rate-hiking cycle.

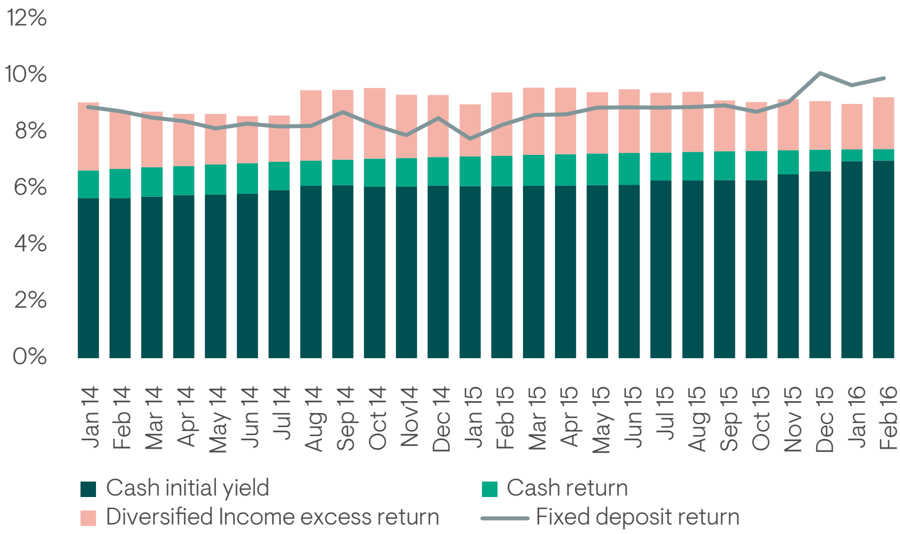
What then delivered the better investment outcome?

To determine which of a flexible fixed income unit trust fund, where we used the Ninety One Diversified Income Fund as a proxy, or a 3-year fixed deposit delivered the better outcome for investors during the rate-hiking cycle of 2014 – 2016, we compared the differences in total return and yield of the Ninety One Diversified Income Fund and a 3-year fixed deposit over this period. The chart overleaf deconstructs the results of this analysis, with the solid gold line showing the annualised return of the 3-year fixed deposit, versus the return decomposition of the Ninety One Diversified Income Fund. Where the stacked bars are above the solid gold line, the Ninety One Diversified Income Fund outperformed the 3-year fixed deposit, and vice versa:

- The dark green bars are the initial cash yields. During the early stages of a hiking cycle, this yield is lower than its level at the end of the cycle. However, the spread between cash yields and fixed deposits tightens as cash rates increase further into the rate-hiking cycle, as increases in the repo rate start to take effect.
- The teal bars show the performance of cash relative to its own initial yield. You can see that cash positively outperforms its initial yield over a 3-year horizon. This means that you would typically receive close to 1% more than what the cash yield implies at inception.
- The pink bars illustrate the annualised return above 3-month cash delivered by the Ninety One Diversified Income Fund, affirming the benefits of a flexible fixed income mandate and active portfolio management, as discussed further below.

It is worth noting that the material impact of 'Nene-gate' on financial markets post the shock firing of then Finance Minister, Nhlanhla Nene in December 2015, and the resultant short-term underperformance of Ninety One Diversified Income Fund in December 2015 and early 2016 - the short-term spike in yields provided investors with a unique opportunity to lock-in very attractive term deposit rates.

Figure 2: Comparing the total return of the Ninety One Diversified Income Fund and a 3-year fixed deposit



Source: Statpro, Bloomberg, Haver & Ninety One, August 2022

In summary, during this previous rate-hiking cycle the Ninety One Diversified Income Fund outperformed 3-year fixed deposits approximately 90% of the time, with an average outperformance of almost 0.2% p.a. And this, with the additional benefit of almost immediate access to your money, as opposed to locking it up for 3 years. In addition, early withdrawal penalties may be charged when accessing a fixed deposit prior to maturity.

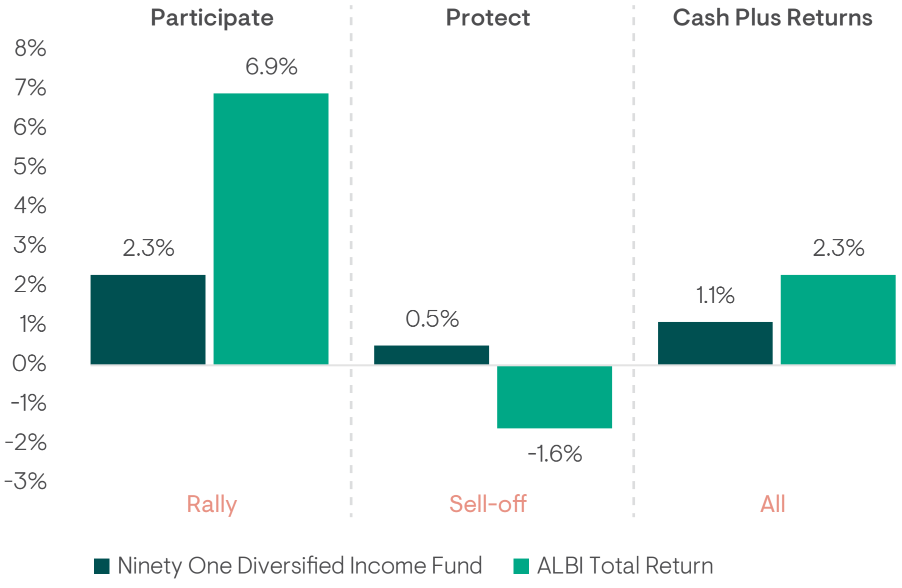
> The decision to lock up money at a fixed rate may prove riskier than investors realise.

Given the uncertain political, economic and investment environment, the decision to lock up money at a fixed rate may prove riskier than investors realise. For example, if fiscal deterioration leads to continued higher yields, the Ninety One Diversified Income Fund's flexible investment strategy allows the fund to adapt and exploit opportunities, whereas the fixed deposit yield will remain static.

Ninety One Diversified Income Fund, designed to participate and protect

The benefit of the Fund's flexible fixed income mandate is not just evident in rate-hiking cycles, but importantly through the cycle. This is evidenced in the following chart, which illustrates the ability of flexible fixed income funds, such as the Ninety One Diversified Income Fund, to make use of a myriad of investment opportunities to diversify risk and enhance the yield of a portfolio. This flexibility has proven extremely attractive and beneficial to investors.

Figure 3: Participating and protecting: average rolling 12-month excess returns over cash



Source: Ninety One and Bloomberg. Returns are based on lump sum investment, NAV based, inclusive of all annual management fees but excluding any initial charges, gross income reinvested, fees are not applicable to market indices, where funds have an international allocation, this is subject to dividend withholding tax, in South African Rand.
Data from 31 December 2010 to 30 June 2022.

The chart compares the return of the Ninety One Diversified Income Fund against the All Bond Index (ALBI) for the 11+ years since January 2011, during periods when the ALBI outperformed cash and when the ALBI underperformed cash.

Some observations:

- When the ALBI outperforms cash (which is does on average by 6.9% p.a.) the Fund participates in these rallies, capturing a third of this outperformance.
- When cash outperforms the ALBI, the Fund protects the downside, delivering a positive 0.5% p.a. above cash.
- As a result, the Fund has outperformed the ALBI over the full period, providing a return of 1.1% p.a. above cash.

In summary, the Fund has delivered upside exposure with downside protection, in line with its dual objective. And while our portfolio construction methodology treats risk and return equally, with market valuations where they are and the income on offer going forward, we anticipate that the Fund will continue to deliver attractive returns relative to cash and fixed deposits.

Contact information

Please visit our website at www.ninetyone.com for more information on our range of funds and portfolio products.

To reach our Ninety One unit trust team, please use telephone: 0860 500 900 or email: utclientservicessa@ninetyone.com

To reach our Ninety One Investment Platform team, please use telephone: 0860 500 100 or email: comcentre@ninetyone.com

Financial advisors: please contact our Advisor Service Centre on telephone: 0860 444 487

Alternatively, please contact your Ninety One investment consultant.

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