October 2020

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Previously Investec
Asset Management

Unpacking the prescribed assets debate and the current fixed income environment

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It's no surprise that the issue of prescribed assets for retirement funds is on the minds of many advisors and their clients. It first became a hot topic after the 2017 ANC Policy Conference, gaining further momentum when the ANC stated in its 2019 Election Manifesto that the introduction of prescribed assets needed to be investigated. Ninety One Deputy MD Sangeeth Sewnath and Malcolm Charles, who co-manages the Ninety One Diversified Income Fund, recently discussed this issue and the broader fixed income environment. These are the highlights from their conversation.

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Uncertainty creates anxiety – but should we be worried?

The possibility of prescribed assets becoming a policy tool of the ANC government has sparked a wide-spread debate in the media about the wisdom of such a move. Investors dislike uncertainty, particularly when it involves their hard-earned savings. Uncertainty typically leads to anxiety and the impulse to do something about it. There have also been discussions in the media about investors choosing not to use retirement vehicles and rather investing on a voluntary basis. The result is that there are significant tax benefits that investors could lose. We wrote a paper on this last year.[1]

While the issue has become emotive for many, it is important to look beyond the daily rhetoric to understand the thinking behind prescribed assets.

In our industry discussions, it has become clear that government and the private sector agree that the 1980s' style of prescribed assets – i.e. forcing retirement funds to hold a minimum proportion of their assets in government debt and related investments – had many more negative consequences than positive outcomes. Our understanding is that behind the investigation of prescribed assets lies the need to bolster investments in high-quality, long-term infrastructure investments. Enoch Godongwana, who is the Chair of the ANC's Economic Transformation Sub-Committee, shared this thinking in recent media interviews.

Finding money to invest does not seem to be the problem

If lack of infrastructure investing is a problem that government is trying to solve, what is the solution? Linda Mateza, the Chief Executive of Eskom's pension and provident fund, has an insightful take on this issue. She recently commented that infrastructure investments are not about finding funding but making projects investible. In fact, there are many infrastructure funds from the banks and life companies, for example, that have stopped raising money because there are too few fundable projects. So, finding money to invest does not seem to be the problem.

In our view, a fundable project is not only about the potential to earn attractive returns for investors. You need a combination of good returns and social outcomes, but sound governance is key to avoid mismanagement and corruption. Government and the private sector recognise the importance of putting the necessary checks and balances in place to ensure the success of such projects. So we, together with many other investment managers, have been strongly focused on understanding the problem we are trying to solve. If it is an infrastructure problem, the answer does not lie in introducing prescribed assets but ensuring that infrastructure projects are fundable. One avenue would be to make use of public-private partnerships.

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1. "Regulation 28 is restrictive – but not in the way you might think", Sangeeth Sewnath, November 2019.

Will the government move towards prescribed assets?

There have been several media articles about potential changes to Regulation 28 of the Pension Funds Act to allow for infrastructure-type investments. In fact, Regulation 28 already makes provision for infrastructure investments up to 35% of a fund's assets – i.e. 25% through debt instruments and 10% through equity. There is no specific mention of infrastructure investments in the regulations, but given how infrastructure investments are structured generally as non-investment grade debt instruments or unlisted equity, it is already permitted.

So, will the government move towards prescribed assets? We see little reason for this, given our observations above. The government may well decide to make changes to Regulation 28 so that infrastructure investment is included in the wording. Our sense is that the government may possibly make the wording more explicit to increase awareness of this asset class rather than as a prescriptive measure. Sceptics may argue that such a move may bring us one step closer to prescribed assets. Ninety One has been engaging vigorously with regulators and other stakeholders. Thabo Khojane, our MD at Ninety One, and Nazmeera Moola, Head of SA Investments at Ninety One, have played an integral part in discussions with government, the investment industry and other stakeholders around this issue.

In a recent Ninety One client webinar, "In conversation with COSATU", Matthew Parks, COSATU's Parliamentary Co-ordinator, said that the labour union federation was opposed to the introduction of prescribed assets. He pointed out that workers' pension funds were meant to take care of workers when they retire and that one should not tinker with funds' mandates.[2]

These sentiments have been echoed by ANC treasurer-general Paul Mashatile, who has "rebuffed suggestions that the government change rules for pension funds to force them to invest in state infrastructure projects".[3] Mashatile was very clear that implementing prescribed assets was not a viable solution and that it would be better to create an environment that was conducive to pension fund investments.

Finding fundable infrastructure projects that offer good investment and social outcomes

Ninety One is always looking at new investment opportunities and recognises the investment potential of high-quality infrastructure assets. If the governance is right and the pay-off profile is correct, there is a lot of money looking for "good homes". It seems that common sense is prevailing; government and industry have moved closer together in their thinking. There is wide-spread recognition of the need to drive new infrastructure investment. Ninety One is committed to help finding solutions that offer attractive returns and sustainable social outcomes that benefit communities at large.

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2. Ninety One webinar, "In conversation with COSATU", September 2020.
3. "ANC stalls plans to nationalise SARB", Moneyweb, 16 September 2020.

Will we see an uptick in economic growth next year?

COVID-19 has decimated the South African economy. We estimate that GDP growth will fall by 7.5 to 8% this year. A key question is determining how much of this decline is temporary and to what extent it reflects lasting economic scars. In other words, which parts of the economy will not recover? How many mom-and-pop shops have been decimated? That is really the crux of the matter.

Over the next few weeks the picture should become clearer as more areas of the economy open (e.g. international travel and tourism). Unfortunately, we think it will take time for tourists to flock back to our market, but we should see a slight uptick. We have experienced a small boost to the economy each time the country has moved to a lower lockdown level. However, the dire economic situation is a big concern. Although the South African Reserve Bank did not lower interest rates again at its September meeting, we could see a rate cut in November or early next year.

A volatile SA bond market reflects ongoing concerns about government finances

The weak economy has had a material impact on government revenue, which in turn has forced the government to issue more bonds to meet its obligations. If the South African government does not come up with concrete actions to stabilise its debt, we may soon find ourselves in a debt trap. We have reached the tipping point. Besides carefully managing government expenditure, economic growth will be crucial to help stabilise government debt and put the country's finances on a healthier footing. While National Treasury seems committed to avoid a debt trap and President Ramaphosa has plans to put South Africa on a growth path, we need to see delivery. There is no shortage of good plans in South Africa, but implementation is key. All eyes will be on the Medium-Term Budget Policy Statement, which will be delivered in a few weeks' time.

How we are positioning the Ninety One Diversified Income portfolio

Exposure to offshore assets plays an integral part as a risk mitigator in an income portfolio. During the height of the market meltdown (March and April of this year), our offshore exposure helped to bolster portfolio returns when the domestic market was under severe pressure. Of course, our level of exposure varies materially depending on market conditions, our currency outlook and other potential risk factors. While our offshore exposure was as a high as 10% during the first quarter, we are currently sitting between 3 and 5%. We expect the rand to be resilient in the near term, given the weak US dollar and South Africa's favourable terms of trade.

We are slightly underweight credit. Institutions are not issuing much paper, plus there is huge demand, so credit is actually quite expensive. We still think there are some attractive opportunities and have maintained a decent chunk of credit in the portfolio.

With cash rates at record lows, government bonds are offering the best yields. Investors can earn in excess of 9 or 9.5% on a ten-year bond, which is very attractive. A combination of government bonds with some foreign exchange exposure to mitigate the risks, allows our investors to earn a decent yield in the portfolio. We have a reasonable allocation to inflation-linked bonds, which also helps us to manage risk in the portfolio.

Listed property is very volatile, and we remain underweight the sector. We think there is some upside potential, but sharp daily swings mean we have to carefully manage our exposure to listed property.

We have a balance of exposures to provide some protection against the multitude of risks locally and globally. This investment strategy has worked well for us during periods where we have experienced bond market volatility or rand weakness.

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