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Previously Investec Asset Management

Resilience counts in volatile and tough markets

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The fast view

- Capital preservation is paramount.
- Global equities still provide the best opportunity for growth.
- Bonds are our preferred local opportunity.
- SA equities have become cheaper, but stock selection remains key.
- The best security is in quality companies with high barriers to entry and pricing power.

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This year has been dominated by concerns about the coronavirus (COVID-19) and the global economic fallout from lockdown measures to contain the spread of the virus. It's been a very tough environment for SA investors, with very few places to hide. Most asset classes had a dismal first quarter – SA equities (FTSE/JSE All Share Index) was down 21%, SA bonds lost close to 9% and listed property almost halved in value for rand-based investors. While global equities (MSCI All Country World Index) shed 21% in US dollars, the sharp depreciation in the rand (down nearly 28% against the US dollar) translated into a rand return for the index of approximately 10% over the quarter.

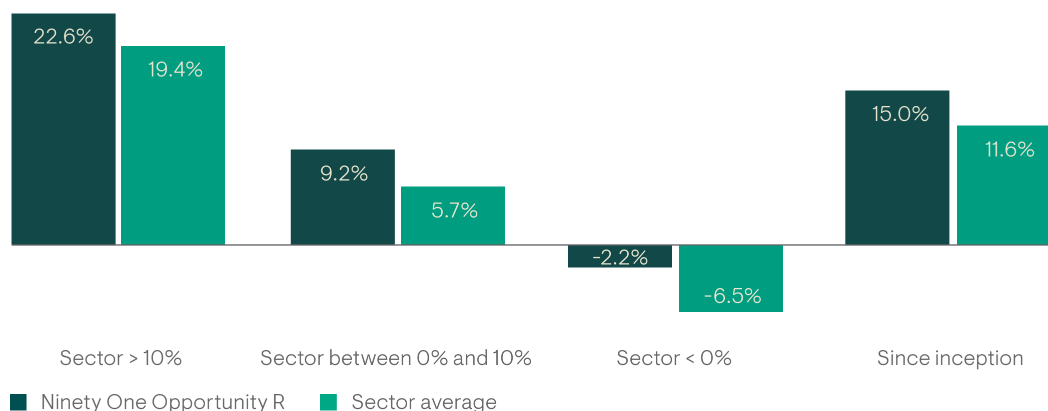
Our Quality local strategies, the Ninety One Opportunity strategy (High Equity Multi Asset) and Ninety One Cautious Managed strategy (Low Equity Multi Asset), have shown resilience amid difficult market conditions, continuing to provide dependable returns for investors. The twin objectives of both these strategies are to outperform inflation over time and to protect capital in difficult periods. Diversification, active asset allocation and disciplined portfolio construction have been important tools in managing downside risk. In the current challenging environment, it is pleasing that over the last 12 months (end March), the performance for both strategies is positive, while they maintain attractive inflation-beating returns over the longer term.

Importantly, both strategies have not only generated positive returns, but have also outperformed the safety of cash so far this year, as we head deep into May.

Showing resilience in various market conditions

The Ninety One Opportunity strategy, which has more exposure to growth assets such as equities, has not only participated meaningfully in rising markets, but has also preserved capital in sideways to down markets. This performance signature is as relevant in navigating markets in 2020 as it was in 2003 or 2009. To appreciate the value of our approach, it is important to look at longer periods where investors have experienced bull and bear markets. Since inception – more than 20 years ago – the Ninety One Opportunity strategy has provided dependable inflation-beating returns while preserving investors' capital through various market conditions, as illustrated in Figure 1.

Figure 1: Ninety One Opportunity strategy relative to sector average over more than 20 years*
Average rolling 12-month performance

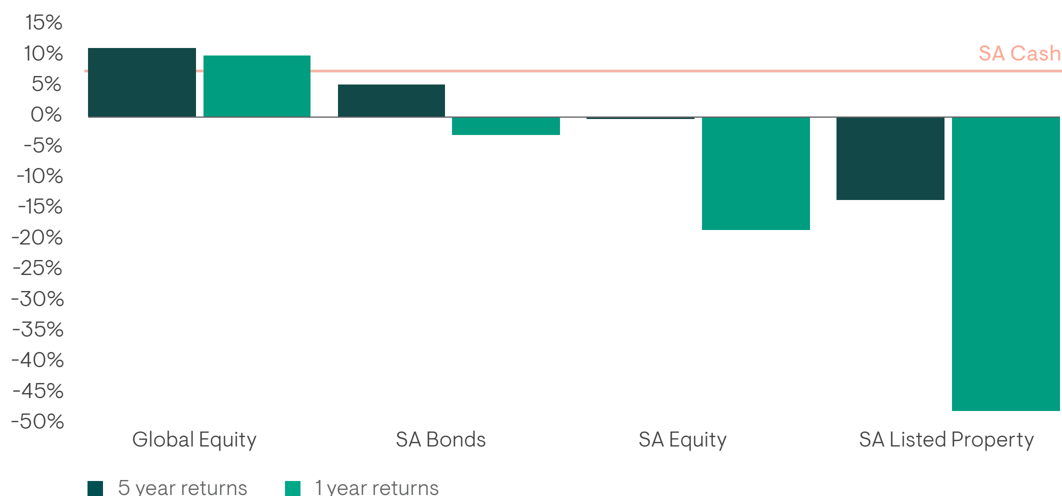


Source: Ninety One. Returns are calculated on a NAV to NAV basis with income reinvested, net of fees.
*Performance inception: 30 June 1997 to 31 March 2020 (22 years and 9 months).
For illustrative purposes only.

Local growth assets have not rewarded investors for taking risk

Growth assets (equities, property and commodities) play an important part in generating inflation-beating returns over time to ensure a sustainable income in retirement. Unfortunately, the performance of local growth assets has been disappointing, not only recently but also over the medium term. South African equities – and in particular listed property – have delivered poor returns over the last five years, significantly underperforming both inflation and local income assets, as can be seen in Figure 2. SA cash has been the winner, apart from global equities.

Figure 2: Local assets have not rewarded investors for taking risk



Source: Source: Ninety One and Morningstar, data as at 31.03.20.

So, how are we generating income and growth in our portfolios?

If you look at the portfolio positioning of our Ninety One Opportunity and Cautious Managed strategies, we have significant exposure to foreign equities (via the Ninety One Global Franchise strategy), and we continue to prefer SA bonds to local equities. Both global equities and SA bonds have been important drivers of return.

We have stuck to our guns of backing quality businesses that will help us deliver dependable returns for investors over time. So irrespective of market conditions, we remain focused on key characteristics such as solvency, liquidity, strong balance sheets and resilient earnings. This unwavering commitment to quality, helped us to materially limit drawdowns during the first quarter's unprecedented market moves. Rand depreciation also helped our SA investors to achieve good returns on the offshore portion of the portfolios.

Quality stocks tend to outperform in difficult market circumstances because of their balance sheet strength and more resilient earnings. Essentially, their financial strength acts as a buffer in times of market stress. We believe that if a company had a good business model going into the crisis, it will most likely continue to have an enduring business after this crisis. Both our multi-asset strategies have exposure to high-quality global equities, which include Johnson & Johnson, Roche, Microsoft, Visa and Nestlé. We are confident that the current valuations still provide investors with significant upside. So, global quality stocks give us the growth in the portfolios.

We balance this exposure with SA government bonds, which provide income. The yields available on SA bonds are very attractive and average more than 9%. Even taking into account downside risk to the fiscus, we believe bond yields still provide a sufficient margin of safety. Interest rates have been slashed and cash no longer offers meaningful above-inflation returns. These actions have caused the yield curve to be steeper than it has been for many years. Yield-hungry investors have sought solace in government bonds as listed property companies have either postponed or suspended dividend payments. Many other SA companies are also withholding dividends, so bonds will remain an important income source.

> Quality stocks tend to outperform in difficult market circumstances because of their balance sheet strength and more resilient earnings.

Will global equities continue to outperform local equities?

This is a key question for asset allocators. The performance gap between local equities and global equities has become very wide, with some investors wondering if it isn't time for SA equities to shine. The macro environment remains very tough. Emerging markets (EMs), particularly commodity producers, have been hard hit. While worldwide lockdown measures due to the COVID-19 crisis have slashed demand, the world economy was already slowing in late 2019. So, the environment has been challenging for EMs for some time now.

We still do not see SA companies offering meaningful growth. South Africa is expected to remain in a recession this year. In fact, we think the economy could shrink by more than 10% in 2020, depending on how soon the country can restore productive capacity as the lockdown measures are relaxed. Based on our scenario analysis, the range of future expectations for SA equities is quite wide and thus we have low conviction in our ability to call the bottom. It is therefore important to be selective and disciplined around security selection on local growth assets. While we have been increasing our allocation to domestic equities, we remain cautious and believe the local equity market may not be adequately pricing in the risks that companies may face in the coming months.

We prefer rand hedges such as British American Tobacco and Naspers, and our local holdings also include short-term insurance leader Santam, and the JSE. Our cash holding gives us scope to take advantage of opportunities at more attractive entry points.

The sharp snap-back in global equity markets that we witnessed in late March, seems to suggest that investors have taken the liquidity bullet and run with it. We estimate there is about US$8 trillion of extra stimulus that has come into the financial system through monetary and fiscal policy measures in the US, Europe, China and the rest of the world. The continued liquidity stimulus provided globally also makes gold attractive in a multi-asset portfolio.

Essentially, markets are saying that earnings and economic data are irrelevant. However, we believe that companies that have a dominant market share and a strong business model, should prove to be resilient during these challenging times. They will be able to survive and will come out stronger once the COVID-19 crisis has dissipated. We are mindful of the risks to global markets. However, we remain confident about the prospects for the concentrated collection of high-quality global stocks we own in our portfolios. We have also been adding to locally listed businesses that should participate in a possible recovery.

> Investors have taken the liquidity bullet and run with it.

In summary

We do not believe it appropriate to position our portfolios for any particular event or crisis. Instead, we maintain a balance of exposures which offers protection against a range of potential outcomes. Global equities continue to be our preferred asset class and bonds our best local opportunity. As always, we remain unwavering in our commitment to growing your capital in a prudent manner.

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