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Ninety One

Previously Investec Asset Management

There is always an alternative

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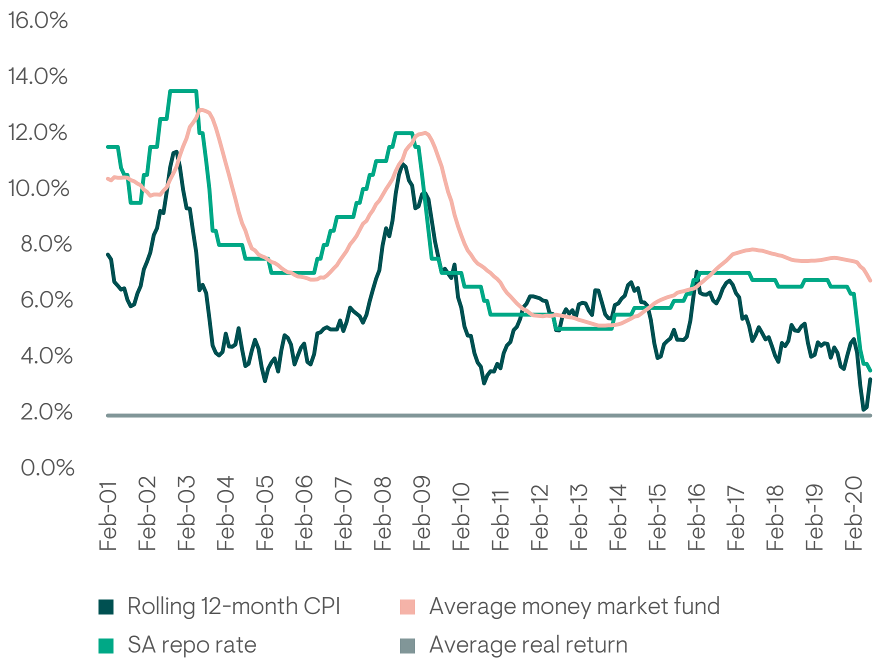
The fast view

Markets are fond of justifying allocations to assets that don't otherwise make sense by shrugging and saying "TINA – there is no alternative." This is clearly not always true, and here we address this fallacy specifically with reference to investing in cash.

Cash investors face a dilemma following an aggressive global rate cutting cycle, which has rendered the asset class unattractive. We have previously addressed this; Figure 1 reproduces and updates the chart presented in "Cash is trending towards trash", published in May 2020. Then, we highlighted the impact of the reducing repo rate on cash returns, which has since shrunk further. Here, we draw your attention to the vastly decreased gap between the repo rate and inflation, which has effectively eliminated real returns for many investors.

Figure 1: South African inflation, interest rates and money market returns



Source: Ninety One Benchmark database.

The annual inflation number of 3.2% to the end of July 2020 marked a significant increase from the 2.2% posted in June. Given a yield from cash of only 3.5%, this implies an after-tax return of less than 2.0%. With inflation at 3.2%, this is a 1.2% negative real return.

Staying in cash at this point will erode the spending power of your money dramatically over the long term, especially given that the South African Reserve Bank (SARB)'s stated preference is for rates to remain low for an extended period from this point.

The search for yield

Clearly, the days of 7% nominal returns from cash are not returning in a hurry. This means that cash investors are faced with a conundrum, as they need to extend their investment time horizon and accept greater volatility of their capital, in order to target a higher yield in the medium to long term. In the current environment this trade-off between security and returns is essential, and there is an attractive alternative in the form of South African bonds.

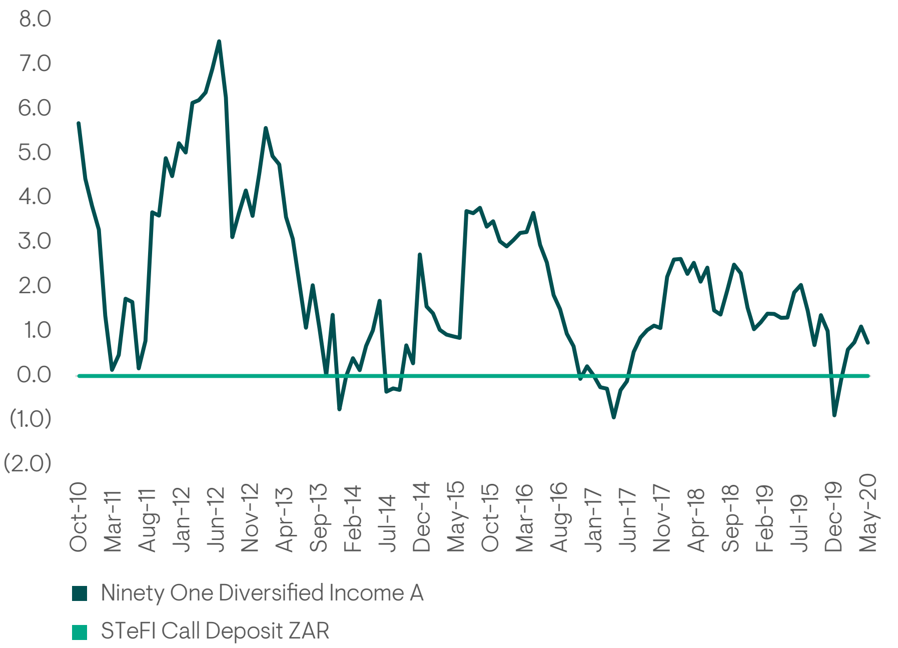
Currently, investors are being compensated for the extra risk of lending to the South Africa government by some of the most attractive real yields to be found anywhere in the world. Moreover, not only do they offer a significant pick up versus cash, there is also potential for some capital growth.

Supporting bonds right now is this very quest for yield and the lack of viable alternatives. However, it is important that the associated risks are actively managed. How can investors access the enhanced returns of South African bonds without taking on all the risk?

The Ninety One Diversified Income Fund

This is where a fund like the Ninety One Diversified Income Fund ("the Fund") can play an important role. The Fund exposes investors to the opportunities presented by SA bonds but provides exposure to credit, property and offshore that also generate returns but also diversify risk. The proof is in the pudding and Figure 2 demonstrates that the Fund has out-performed cash 90% of the time over all rolling 12-month periods and by an average of more than 2% per annum. Given the current yield of the portfolio (Net historic yield: 7.05%, as at 31 August 2020) and potential for a capital growth contribution to total return we believe that the portfolio could comfortably exceed cash returns over the medium to long term. When assessing the risk represented by the Fund, financial advisors and their clients can take comfort from the fact that it was one of the only flexible fixed income funds that posted a positive return in the first quarter of 2020.

Figure 2: Stacking the odds in your favour



Past performance is not reliable indicator of future results, losses may occur.
Source: Morningstar, dates to 31 August 2020, performance figures above 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.
*Performance inception date: E share class: 3 October 2011
Highest and Lowest returns are those achieved during any rolling 12 months over the period specified.
*Since inception: January 2013: 22.7% and November 2018: -1.2%. The fund is actively managed.
Any index is shown for illustrative purposes only.

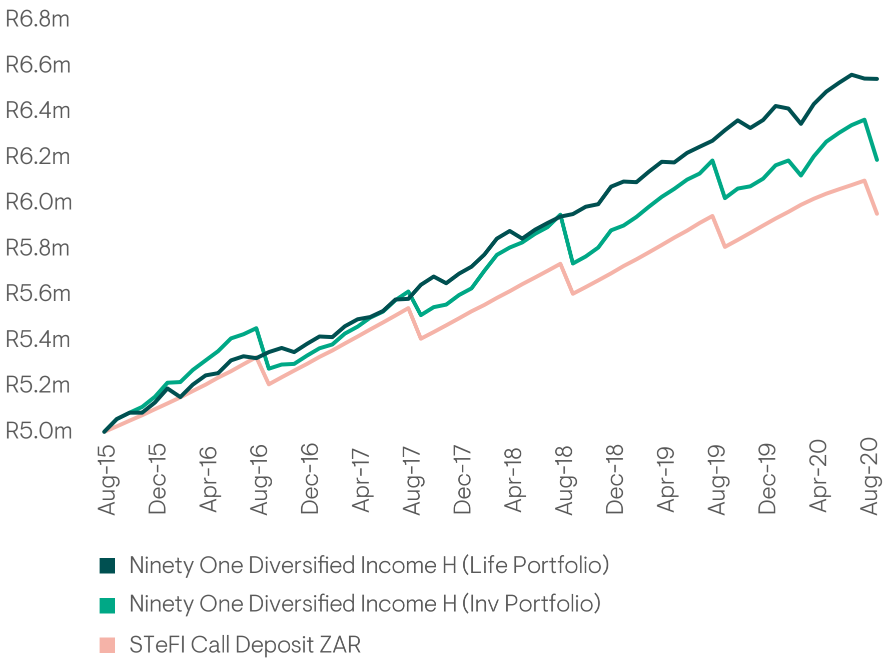
Enhancing returns further

In an environment where the yields on shorter-dated instruments are under pressure every basis point of return takes on increasing importance.

Another means of enhancing the returns on offer is to use tax efficient products to reduce the impact of tax and so boost returns. The Ninety One Life Portfolio is a product that allows you to do just that.

It is structured as a sinking fund policy which means that it is taxed as per the five funds approach. From a fixed income investors perspective this represents a significant tax arbitrage opportunity. Any portion of your growth that comes in the form of income is taxed at 30% within the policy, rather than the 45% a higher rate taxpayer or trust typically pays. Figure 3 shows the impact that saving a third of your income tax bill can have when compounded over a five-year period. The benefit has added 1% per annum over the past 5 years for investor's paying 45% marginal tax. There is typically no premium for buying the Ninety One Diversified Income Fund via the Life Portfolio versus buying the same Fund directly, which means that the tax saving effectively come for free. And that is even before the estate planning benefits the product wrapper provides which, whilst beyond the scope of this article, are significant.

Figure 3: Maximizing returns from fixed income



Source: Morningstar and Ninety One. Performance net of fees from 1 September 2015 to end August 2020. Performance of H class of Diversified Income adjusted to reflect the impact of platform fees in both Investment Portfolio and Life Portfolio illustrations. 45% income tax deducted from annual growth on STeFI call deposit illustration and Diversified Income Investment Portfolio illustration, 30% income tax deducted from quarterly returns on Diversified Income Life Portfolio illustration.

In an environment where cash investors are faced with significant negative real returns the Ninety One Diversified Income fund offers a compelling alternative to vanilla cash. This advantage is likely to be increasingly pronounced in the years to come and may be enhanced by investing via the Ninety One Life Portfolio. While there is not always good news in the market, there is almost always an alternative.

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Investment Process: Any description or information regarding investment process or strategies is provided for illustrative purposes only, may not be fully indicative of any present or future investments and may be changed at the discretion of the manager without notice. References to specific investments, strategies or investment vehicles are for illustrative purposes only and should not be relied upon as a recommendation to purchase or sell such investments or to engage in any particular strategy. Portfolio data is expected to change and there is no assurance that the actual portfolio will remain as described herein. There is no assurance that the investments presented will be available in the future at the levels presented, with the same characteristics or be available at all. Past performance is no guarantee of future results and has no bearing upon the ability of Manager to construct the illustrative portfolio and implement its investment strategy or investment objective.

In the event that specific funds are mentioned please refer to the relevant minimum disclosure document in order to obtain all the necessary information in regard to that fund.

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Contact information

For more information and assistance with investing,
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www.ninetyone.com

Alternatively, please contact your Ninety One investment consultant.

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