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PRIVATE Wealth

ASSET ALLOCATION AMID GLOBAL AND LOCAL TRENDS

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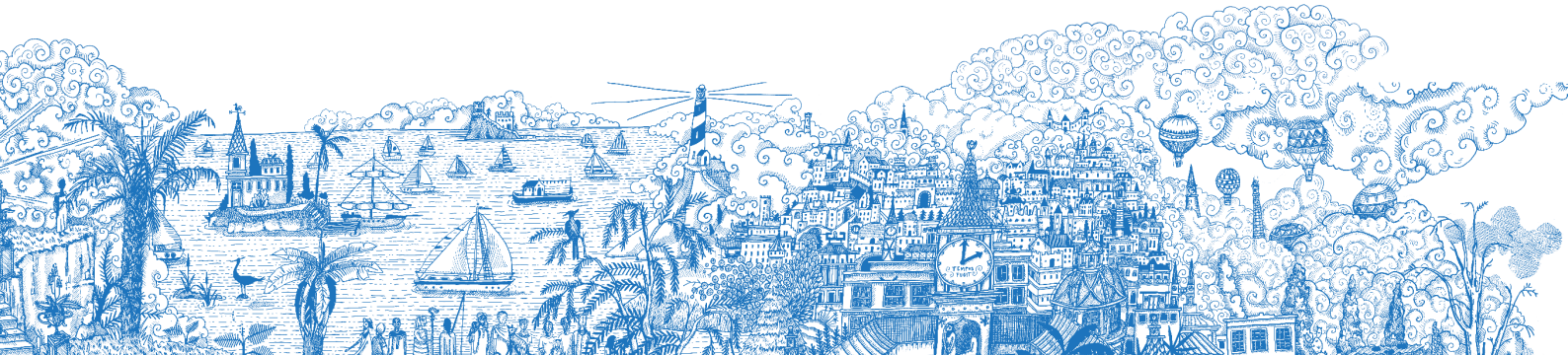
Investors were certainly disappointed with the investment returns that were generated during the calendar year 2018 – in fact, not only during 2018, but in the three years leading up to the period. Generally, investors were not rewarded for the risks that they've taken by investing in growth assets. South African equities, South African property, and even global equities gave a negative return during the calendar year of 2018 in dollar terms.

At the beginning of the year, we certainly acknowledged the problems in the financial markets. However, we also cautioned against overly pessimistic behaviour by investors. The reason for this was simply that we thought that many of the asset classes that did not perform well showed enough value to justify the risk of investing in those asset classes.

If you look at the investment performance that was generated during the first quarter of the year, investors who were patient enough to stay around in those asset classes were certainly rewarded for the risk. South African equities are up by about 11% in rand terms since the beginning of the year. If you invested in US equities, you're up by about 13%, and most European equity markets are also up in double digit numbers. So for the patient investor, there was certainly reward.

The investment narrative hasn't changed much since the beginning of the year. However, there was one big change that we need to focus on. In December last year, many investors were still very concerned about the approach of the Federal Reserve in the US in terms of implementation of monetary policy. During the second half of 2018, the Fed was generally quite hawkish. In other words, investors expected the Fed to hike interest rates, as economic activity was quite robust in the States, and the Fed was to some extent concerned about a high inflation rate.

In December, the Fed changed its stance when it started to focus on slower economic activity in the rest of the world, and also the lack of any significant signs of inflation emerging in the States. And as a result of that, the Fed became quite dovish and indicated that the higher interest rates that the market expected, in all likelihood will not emerge. As a result of that, the market became quite positive, and growth assets in particular performed very well.



Suddenly, investor sentiment changed. The question that we should ask ourselves today: is that particular approach sustainable? And where does it leave us in terms of asset allocation? To answer the question, I want to go back to the ground principles that we normally apply when we decide on asset allocation. The first thing that we try to establish is where we are in the broader economic cycle. The second factor we will always take into consideration is the pricing of the particular asset class. I don't think there is any change in our view in terms of where we are in the economic cycle. Following the great financial crisis in 2009, we are now in the 10th consecutive year of economic expansion in the world, with the US growing at an extremely firm pace. I think it is just normal to expect that this cycle will at some point start to lose steam and roll over. Late in the cycle, we would normally tell clients to be a bit more cautious in terms of their asset allocation approach.

So that is the first point to make. Secondly, if you look at the valuation in terms of global equities, there is no doubt that following the decline in equity prices in the second half of last year, we were more comfortable with the valuation. The recent bounce in those equity prices took equities to a slightly higher elevation, but I don't think there is a substantial risk of an all-fall-down kind of situation for equity markets. However, the recent bounce, and the fact that we are in a late cycle, would imply to us that the prospective returns for the next three or five years must come down. We would expect global equities, and US equities in particular, to generate a return of between 5% and 10% on average over the next three to five years – which is significantly lower relative to the performance that we saw over the last 10 years.

If we turn to South African asset classes, I think we've got to apply exactly the same logic. Firstly, if you look at our cycle, the South African economic cycle never coincided with the strong performance that we saw from the global market, as a result of the very unique problems – particularly on the political front – that we've experienced over the last 10 years. As a result of that, last year for the first two quarters we had negative growth. It picked up a bit in the second half of the year. But still, I think it is true to say that the South African economic performance was only pedestrian.

As a result of that, many of the companies that generate their profit stream from the South African economy, those profits that we've seen were rather below par, and those equities didn't perform well. The more rand-hedge orientated shares, in other words shares that generate their profits largely from overseas sources, their performance was quite good, not only on the profit side but also on the performance side.

Nevertheless, if you look at the market as a whole, despite the fact that the economic outlook hasn't really changed much, the valuation looks quite attractive to us. Quite often, people say to us, if you are not entirely comfortable with the economic outlook for South Africa, how can you buy an asset where the profit is associated with the well-being of the economic cycle – how can you be comfortable with that asset? If you look at the valuation of the South African market, the market is now trading at a price-earnings multiple of about 11 times, which is now below its long-term mean, and it's a number that we haven't seen for quite some time. So what we believe is when equity prices pull down, investors generally extrapolate the negative narrative into perpetuity. And we don't think this is the right thing to do.

So if we look at it from a top-down perspective, it looks like we can identify value. But very importantly, when we actually analyse individual companies, we can see quite significant upside on the individual companies. This provides us with enough comfort that South African equities, over the next investment cycle, are likely to reward investors justifiably for the risk that they've taken by investing in this particular asset class.

We've spoken about equities, we haven't spoken about other South African asset classes. I think the other asset class that was a major disappointment over the last three to five years, was listed property in South Africa. Over the last three years, listed property lost about 3% per annum in terms of value. For the first time, I think, over this particular period, listed property is looking attractive, given the yields they are trading at. On average, the listed property market is trading at yields of between 9% and 10% at the moment. If inflation is about 5%, that yield is a 5% real yield that in historic terms certainly looks attractive.

However, we think we still need to caution investors not to inflate their expectations with those high yields. There is no doubt that the property sector has overinvested in capacity, and it will take more time for that overcapacity to be eroded. Therefore, we think those yields are likely to remain under pressure. Nevertheless, when we look at the bottom-up scenario, in other words, when we look at individual listed counters, there are some of these counters that are starting to look quite attractive, and we will start to accumulate these in client portfolios.

That leaves us with the last local asset class – fixed interest investments. If you look at the last five years, government bonds was the best performing asset class. It gave you a return of about 8% per annum over the five-year period. Traditionally, the price performance of fixed interest assets are not well correlated with equities. So it provided some risk aversion to a diversified portfolio.

However, my big concern about the South African economy is the fact that from a fiscal perspective, there is an enormous amount of risk associated with South Africa. The whole Eskom debacle is still escalating, and we still don't fully understand to what extent the government will have to take responsibility for the huge debts that they need to service on behalf of Eskom. As a result of that, we've always been very cautious, and we remain cautious on the particular asset class. In our minds, those yields must still move much higher, in other words, those government bonds must trade at much cheaper levels before we will consider them for an investment portfolio. We would much rather prefer fixed interest investments in the shorter end of the spectrum, to compensate us for the risk that we take to invest in that particular asset class.

To summarise, we were delighted with the performance of asset classes across the whole spectrum, but in particular with the risky asset classes since the beginning of the year. It certainly corresponded with the view that we held at the beginning of the year, but we want to warn against over-optimism given the very strong start to the year. So I think we are in for a more normal period from a global perspective, but in South Africa, we still need to fasten our seatbelts, because it might still be a rocky ride towards the end of the year.

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