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Investment Managers

QUARTERLY COMMENTARY – Q4 December 2017

Granate *SCI Multi Income Fund

Fund Profile

The Granate SCI Multi Income Fund is a domestic income portfolio which seeks to provide investors with consistent positive returns and minimal volatility. The objective of the portfolio is to deliver real returns in excess of money market and traditional income portfolios over the medium to longer term. Investors are primarily exposed to the fixed income and credit markets.

The portfolio aims to optimize risk-adjusted returns by strategically allocating within the various sources of the fixed interest and credit universe according to current valuations. The portfolio will optimize the yield of the portfolio whilst compensating as far as possible for the underlying risk. This is done by focusing mainly on credit and yield enhancing strategies, whilst very moderate duration strategies are employed. The portfolio is managed in accordance with regulations governing pension funds and CISCA.

1. Economic overview

Global economic activity in the 4th quarter of 2017 continued to improve and the business cycle upswing is now in its 9th year as interest rates remain low and inflation is, in most countries, below target despite tightening labour markets. 2018 is promising to build on last year's momentum as financial conditions and improved sentiment combine to provide another year of synchronized global growth.

Domestic economic data activity remained relatively weak in the 4th quarter, although the economy is expected to have maintained positive growth after expanding by a quarter-on-quarter annualized rate of 2% (0.8% year-on-year) in the 3rd quarter. The SARB composite of leading indicators continues to improve as does the ABSA PMI which recorded its 4th consecutive increase, albeit remaining below the all-important 50 level for a 6th month. While a significant confidence boost will support economic growth over the next quarter or two, South Africa's growth is likely to remain below trend for the foreseeable future.

Major central banks continued to communicate to the market a more hawkish outlook for interest rates, although it is only the US (FOMC) and the UK (BOE) that raised policy rates among the main central banks during the quarter. The FOMC remains by far the most hawkish major central bank and after raising its lending rate 3 times in 2017 (from 0.75% to 1.5%) and embarking on shrinking its balance sheet is expected to continue its tightening policy in 2018.

In South Africa, the Monetary Policy Committee (MPC) of the Reserve Bank met once in the 4th quarter (November) and left the repo rate unchanged at 6.75%, a unanimous decision by the six MPC members. The November statement set a more hawkish tone than in September (although with the same decision despite a split MPC vote) as the committee considered risks to the inflation outlook to have increased, mainly due to higher international oil prices and a weaker rand exchange rate. Risks to growth, on the other hand, were deemed to be on the downside. The decision was also affected by the "rapidly deteriorating fiscal position" which the statement said "…could potentially reduce the scope for further monetary policy accommodation".

While two of the three main upside risks to domestic inflation raised by the MPC (weaker currency, Eskom price increases, and higher international oil prices) have subsided, currency weakness is likely to return as fiscal consolidation remains a challenge that will not vanish anytime soon. This means that Moody's will downgrade South Africa's credit rating to below investment grade and tax hikes will keep inflation from remaining at or below the middle of the target range. Therefore, we think that the MPC will change its view on the risks to inflation to be balanced, but keep the repo rate unchanged for the foreseeable future.

2. Market overview

South African financial markets had a nervous and volatile quarter as investors faced the difficult task of weighing up the probabilities of different ANC elective conference outcomes.

The property sector was the best performing domestic asset class (+8.3%) followed by equities (+7.4%), bonds (+2.2%), Money Market (+1.8%), and Inflation-linked bonds (+1.0%). For the 12 months to the end of December all domestic asset classes offered positive inflation adjusted returns other than inflation-linked bonds which lagged inflation by approximately 1.8% and is now the only asset class to return negative real returns over the last 5 years.

The quarter started poorly for bonds having returned -2.3% and -1.0% in October and November, respectively, but a very strong rally in December (+5.7%) resulted in the asset class returning a respectable 2.2% for the quarter.

Unsurprisingly, given the stellar performance of bonds, the property sector had a strong 4th quarter outperforming all other asset classes as some of the heavyweights in the SAPY index had a strong December while those with a greater exposure to foreign markets performed better in October and November.

The strong performance in income generating assets was supported by a strong rally in the rand which gained 10.62% against the USD in December, its 2nd best monthly performance since 2000. The rand was obviously driven by improved sentiment towards South Africa and strong commodity prices, although we think at current levels it has overshot and unlikely to strengthen much further.

3. Portfolio activity

Our income fund positioning remained cautious over the past quarter, although we increased duration slightly from 0.4 to 0.62 to take advantage of the extremely positive valuations on bonds. We still favour the banks, insurers and higher quality corporates and have been actively seeking opportunities in these sectors to increase the yield in the fund. Although credit spreads have been on a narrowing trend, we believe that we have reached the bottom and given recent events in the market including Steinhoff, they could start to widen from here. We are keeping a high level of liquidity in the fund in order to take advantage of opportunities that may emerge in the credit space. We have recently increased our positioning in property and are finding the UK property stocks particularly cheap. We continue to focus on keeping the yield in the fund as high as possible by investing in high quality credit, whilst minimizing downside interest rate risk in this volatile environment.

4. Portfolio positioning

The favourable outcome from the elective conference in December had a very positive impact on the market and we believe that the market is now pricing in fiscal consolidation and a stable rating outlook, or no further downgrades by Moody's.

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It remains to be seen whether this is justified, as the challenge of getting South Africa back on a solid growth path, reducing government's debt burden and achieving reform in the SOE sector is monumental. None the less, with a more stable political outlook, we believe that there will be opportunities in the multi income space to be less defensive over time as more policy certainty will mean increasing robust investment by the public and private sector into the economy.

This will ultimately lead to better and more diverse corporate bond issuance. Our large weighting to the banking sector and high quality corporates has benefitted the fund and has been a prudent approach in this volatile environment, but we will start to look for opportunities in other sectors as they become available. The fund will always be defensively positioned in terms of duration (not likely to go higher than 1.2) but will also look for opportunities to go slightly longer in the near term as we believe there is likely to be more positive market sentiment based on the strong Rand as well as global fundamentals. We are unlikely to increase our weighting to inflation linkers in the near term as the strong Rand has had a very positive impact on inflation, and nominal bonds are looking better than inflation linkers from a valuation perspective. We will also be looking for opportunities to increase our property exposure to a more neutral weighting in the fund.

Granate SCI Multi Income Fund – Portfolio Manager Profile

Bronwyn Blood (B.Com (Hons))

Prior to joining Granate Asset Management in December 2015, she was the Portfolio Manager of the Flexible Fixed Interest Funds and the flagship Absolute Yield Fund at Cadiz Asset Management. When Cadiz bought African Harvest in 2006 Bronwyn took over the management of the Flexible Fixed Interest funds.

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Disclosures

The portfolios were managed by Momentum Collective Investments (RF)(Pty) Ltd prior to 28 November 2017. Sanlam Collective Investments (RF) (Pty) Ltd, a registered and approved Manager in Collective Investment Schemes in Securities and the Manager retains full legal responsibility for the co-brand portfolios. Collective investment schemes are generally medium- to long-term investments. Past performance is not necessarily a guide to future performance, and that the value of investments / units / unit trusts may go down as well as up. A schedule of fees and charges and maximum commissions is available from the Manager on request. Collective investments are traded at ruling prices and can engage in borrowing and scrip lending.

The Manager does not provide any guarantee either with respect to the capital or the return of a portfolio. Performance is based on NAV to NAV calculations with income reinvestments done on the ex-div date. Performance is calculated for the portfolio and the individual investor performance may differ as a result of initial fees, actual investment date, date of reinvestment and dividend withholding tax. The manager has the right to close the portfolio to new investors in order to manager it more efficiently in accordance with its mandate. A money market portfolio is not a bank deposit account. The price is targeted at a constant value. The total return to the investor is made up of interest received and any gain or loss made on any particular instrument and in most cases the return will merely have the effect of increasing or decreasing the daily yield, but that in the case of abnormal losses it can have the effect of reducing the capital value of the portfolio.

Excessive withdrawals from the portfolio may place the portfolio under liquidity pressures and in such circumstances a process of ring-fencing of withdrawal instructions and managed pay-outs over time may be followed. Seven day rolling yield is calculated by taking into account the interest earned by the fund during a 7 day period minus any management fees incurred during those seven days. Income funds derive their income primarily from interest-bearing instruments. The yield is a current and is calculated on a daily basis. Annualised return is the weighted average compound growth rate over the period measured. The portfolio management of the funds is outsourced to Granate Asset Management (Pty) Ltd (FSP no. 46189), an authorised financial services provider in terms of the FAIS Act.