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Investment Managers

QUARTERLY COMMENTARY – Q1 2018

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

Economic activity in major economies maintained its strong momentum during the 1st quarter of 2018. Furthermore, consensus forecast for economic growth for both developed and developing economies for 2018 and 2019 have been revised upwards. These upward revisions to economic growth have come despite the increasing risk of "trade wars" as countries are retaliating to the US's imposition of trade barriers and rising policy rates in the US.

Domestic economic data for the 4th quarter of 2017 (released during Q1 2018) showed that the economy is in better shape than previously thought. The domestic economy grew by a quarter-on-quarter annualised rate of 3.1% (1.9% y/y) in the 4th quarter of last year, after recording an upwardly revised 2.3% growth rate in the 3rd quarter. The primary sector (mainly agriculture) remained strong, but encouragingly, both the secondary (manufacturing) and tertiary (trade) sectors rebounded.

Q1 2018 data has been, on balance, encouraging. PMI's, business and consumer sentiment, and mining production have improved while manufacturing production and retail sales have softened, albeit from a strong performance in Q4 2017.

The Monetary Policy Committee (MPC) of the Reserve Bank met twice during the 1st quarter. While both MPC meetings took place after the change in the country's leadership, the situation was very different amongst the two meetings. In the January meeting the economy was still facing significant fiscal and thus rating downgrade risks. Therefore, while inflation was falling and the economy weak, the SARB kept the repo rate unchanged as five members of the MPC voted for no change and one member voted for a 25bp cut. When the MPC met in March, two of the key risks that the economy was facing in January were gone, namely further fiscal deterioration and the rating downgrade. Furthermore, consumer and business confidence showed a marked improvement. This, together with the fact that the committee's inflation forecast was lowered, led to a 25bp repo rate cut. Surprisingly, however, the March MPC statement was relatively hawkish and the decision was a close call as three of the seven (a new member was appointed to the MPC) voted for an unchanged repo rate.

The March MPC statement suggests that a further rate cut this year is in the balance. Inflation has continued to decline, but the 1% VAT increase, higher oil prices and base effects suggests that inflation has probably bottomed in the 1st quarter. This, together with the MPC's increased focus on the middle of the inflation target band (4.5%) as where it wants inflation expectations to settle, suggests that a further 25bp cut is not a given. A favourable outcome in the public-sector wage negotiations, if obtained, could be the deciding factor.

2. Market overview

The South African bond yields continued their downward trend in 1st quarter of 2018, with the yield on the benchmark R186 declining by 60 basis points (bp) and the All Bond Index (ALBI) recording its best 1st quarter return on record. The rally in the bond market started at the end of November last year, but picked up significant momentum during the ANC elective conference once it became evident that the "Zuma camp" had lost its grip on power. The downward trend in yields was mainly a result of the market "pricing out" the political risk (with all its implications on the economy) that was being discounted in the bond market.

The chain of events triggered by the favourable outcome of the ANC elective conference culminated in Moody's decision not to downgrade South Africa's credit rating – a move that would have probably resulted in large spike in yields as foreign investors would have sold their local bond holdings. Importantly, the credible budget presented (which still needs to be delivered on) by National Treasury, which articulated a path towards fiscal consolidation, has meant that government will borrow less and reduce the size of its weekly bond auctions. The improved fiscal outlook and the resultant decline in borrowing has resulted in a flattening of the yield curve during the quarter with the aggregate yield on the 12+ sector of the yield curve declining by 77bp points compared with that of the 3-7 sector of the yield curve which fell by only 34bp.

Inflation-linked bonds, which have been out of favour for the best part of the last two years, also ended up having a strong quarter (4.15%) courtesy of a March rally which saw yields fall by between 15bp and 39bp on short and long dated bonds, respectively.

After being the best performing domestic asset class in the 4th quarter of 2017 (+8.3%), the property sector was the worst performer (-19.6%), registering its worst quarterly return since the middle of 2006. The selloff was concentrated in four shares that are part of the Resilient group, which make up 27% of the JSE property index, and accounted for 15.2% of the 19.6% loss of value in the sector.

3. Portfolio activity

Our duration position has increased to 0.96 (from 0.62) as we took advantage of the more stable bond market outlook. The income fund benefitted from this as the market continued to rally on positive news flow in terms of the budget, the rating reprieve from Moody's, and expectations of an interest rate cut. The corporate bond market also continued to perform well as spreads continued their narrowing trend. We still favor the banks, insurers and higher quality corporates and have been actively seeking opportunities in these sectors to increase the yield in the fund. We are now starting to look for opportunities in the SOE sector again as the leadership changes in this sector bring about better governance and financial stability prospects, and the sector looks more fairly priced.

We have reduced the level of cash in the fund as we took advantage of credit opportunities in the secondary market over the quarter. The secondary credit market continues to be a good alternative for sourcing credit as primary auctions remain subdued and private placements are continuing behind the scenes. We continue to increase our positioning in property and are finding the UK property stocks particularly cheap, but we are also favoring some of the larger South African REITs.

We have no exposure to preference shares as the pricing in that market continues to be unreflective of the underlying fundamentals, and is based more on demand supply dynamics, which are difficult to analyse. 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

Although we have increased duration in the fund somewhat, our portfolio position remains defensive. The fund will always be defensively positioned in terms of duration (not likely to go higher than 1.2) and will have the majority of exposure to floating rate bonds. We believe we are exposed to the more stable sectors in the corporate bond market and have stayed out of the lower rated corporates which have experienced liquidity problems in the recent past. Inflation linkers will remain a low weighting in the fund as we see more value in the nominal bond market. We believe that over the long term we should be increasing the weighting in inflation linkers as the lower volatility nature of this asset class suits the objectives of this fund. We are also underweight in listed property but are looking to increase this position marginally.

As the fund grows we can diversify appropriately and in line with our credit policy, across the corporate bond market. We are extremely comfortable that we are well positioned across corporate South Africa, given the current economic environment. Our positioning in the fund remains overweight on banks and insurers and we are likely to increase our exposure to securitizations further in the near term.

Our credit policy has embarked on a process to make sure our sectoral breakdown is more granular and will focus on keeping exposure low to corporate sectors which are more prone to liquidity issues due to the nature of their business. Our credit process is also very focused on making sure we have exposure to the sectors where there is sufficient risk compensation built into the credit spreads. We are thus cautiously optimistic on the SOE sector as this sector is starting to look more fairly priced. We do not see our positioning within the corporate sectors changing much in the near to medium term, but with credit spreads narrowing so significantly we feel that there may be less value in the corporate market. This warrants being more price sensitive which should result in a larger weighting to cash in the fund going forward.

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.