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Investment Managers

QUARTERLY COMMENTARY – Q3 2018

Granate *SCI Money Market Fund

Fund Profile

The objective of the Granate SCI Money Market Fund is to provide investors with a way to participate in a diversified portfolio of money market instruments that ordinarily are either not available or offer a lower yield to retail investors. The primary performance objective of the portfolio is to obtain a high level of current income as is consistent with capital preservation and liquidity. Capital gains will be of an incidental nature. The portfolio is managed in accordance with CISCA and Regulation 28 of the Pension Funds Act. The portfolio will be allowed to invest in listed and unlisted financial instruments (derivatives) as allowed by the Act from time to time, in order to achieve the portfolio's objective.

This is an ultra-conservative portfolio that caters for an extremely low risk tolerance and is designed for minimum capital fluctuations and volatility. It carries a short time-frame for investment. There are no growth assets in this portfolio and it is a cash-based investment. The ultraconservative portfolio aims to yield returns that are higher than bank deposits and typically higher than inflation. Capital protection is of prime importance.

The portfolio is bound by the exposure limits as per the ASISA fund classification structure applicable to South African - Interest Bearing - Money Market Portfolios. Money market instruments with a maturity limit of less than thirteen months, the average duration of the underlying assets may not exceed 90 days and a weighted average legal maturity of 120 days.

1. Economic overview

Economic activity in major economies remained generally strong although there are some signs that growth momentum is slowing as the upswing is now in its 10th year and uncertainties around the impact of "trade wars", Brexit, and higher oil prices weigh on markets. These uncertainties have negatively impacted emerging markets as evident by a significant spike in market volatility and below-expectation data releases.

Domestic economic data for the 2nd quarter of 2018 (released during Q3 2018) showed that the economy is in worse shape than previously thought, having moved into recession for the first time since 2009. GDP contracted at a seasonally adjusted quarter-on-quarter annualised rate of 0.7% in the 2nd quarter, after recording a downward revised 2.6% contraction in the 1st quarter of 2018. 3rd quarter data has been mixed with retail and manufacturing growth improving while the mining sector slowed down meaningfully. Overall, however, economic growth is expected to improve in the 2nd half of the year, albeit to levels which are below potential.

The Monetary Policy Committee (MPC) of the Reserve Bank met twice during the 3rd quarter and kept the repo rate unchanged at 6.5%. While the repo rate was kept unchanged, the message delivered by the MPC has become progressively more hawkish as also evident by the fact that in its last meeting (September), 3 of the 7 members voted for a 0.25% rate hike. The MPC's decision has been made more difficult since the economy weakened by more than it had expected, while the currency depreciated by 11% between the two meetings. Therefore, it concluded that whilst the risks to inflation are to the upside (due mainly to external factors), demand pressures do not appear to pose a significant risk to inflation.

2. Market overview

After a poor 2nd quarter of 2018 for yield instruments, money market rates continued their upward trend in the 3rd quarter of 2018, albeit at a much slower pace. The 3-month Negotiable Certificates of Deposit (NCD) rate ended the quarter flat at 6.95%, while the 12-month NCD rate ended 17.5bps higher at 8.3% (Q2: 8.125%). Money market rates were, however, volatile with the 12-month NCD trading in a 40-basis point range. The move in rates coincided with the move in the rand and consequently changes in repo-rate rate expectations.

The rand's fall in the month of August had initially led market participants to price in a steeper hiking cycle over the next 18 months. The market moved to price in a 100% probability of a rate hike by the end of the year from 32% in the previous month. Expectations of a rate hike by the end of 2018 eased to 70% at quarter end as the rand recovered some of its losses and data released in the SARB quarterly bulletin confirmed that consumer demand remains weak.

The money market curve continues to price in a gradual and moderate repo-rate hiking cycle which is consistent with the Reserve Bank's Quarterly Projection Model. This is despite the weakness in the currency and the sharp rise in petrol prices which suggests that monetary policy credibility continues to grow.

Rising global policy rates, the weaker rand, higher petrol prices, stubbornly high administrative prices and prospects for stronger growth means that policy rates will rise over the next 18 months with a high probability of a 0.25% increase in the repo rate by the end of the year.

3. Portfolio activity

We started the 3rd quarter with higher exposure to longer term fixed rate money market assets. During the quarter, we continued this strategy as the yield of these instruments trended higher. As market participants priced in a steeper rate hiking cycle, our valuation models indicated that the longer term fixed rate money market instruments offered significant positive risk compensation. Thus, the portfolio benefitted by holding these higher yielding assets.

However, as the money market curve flattened, towards the end of the quarter, longer term fixed rate money market instruments were no longer offering sufficient risk compensation. At that stage, we began shifting investments into floating rate instruments as Jibar rates reached abnormally high levels and funding rates remained attractive.

4. Portfolio positioning

As mentioned previously, the money market curve continues to price in multiple repo rate hikes over the next 12 months. This is consistent with the SARB's Quarterly Projection Model and given the change in economic and market variables over the quarter, we think the market may be correct in its view. The risk to the view is fewer repo-rate increases because of the weak local economy and the absence of demand-pull inflation.

Currently the portfolio has a higher exposure to floating rate bank paper. Given the high probability of a repo-rate hike by year end, we believe that this is the correct strategy as the floating rate notes will benefit if the SARB increases the repo-rate at future meetings.

The money market portfolio maintains a high level of liquidity through call deposits and bank paper.

Granate SCI Money Market Fund – Portfolio Manager Profile

Vaneshen Naidoo (MSc - Eng, CFA)

joined Granate Asset Management in December 2015 and currently manages the Money Market and Cash portfolios in the Fixed Interest Team. He joined Cadiz Asset Management in 2006 as a graduate and during this time analysed the credit and property sectors for the fixed interest and multi asset class teams. Vaneshen holds a BSc. Hons (Engineering) and M.Sc.(Engineering) from The University of Cape Town, and is also a CFA.

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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.