QUARTERLY COMMENTARY – Q3 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 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. Rising global policy rates, the weaker rand, higher petrol prices, stubbornly high administrative prices and prospects for stronger growth mean 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.

2. Market overview

After a very poor 2nd quarter of 2018 for domestic bonds where the All Bond Index (ALBI) returned -3.8%, bond yields continued to rise, albeit at a much slower pace in the 3rd quarter with the yield on the benchmark R186 rising by 15.5 basis points (bps) and the ALBI returning 0.81%. The quarter was characterised by a significant spike in emerging market currency and bond volatility led primarily by concerns around Turkey's economic outlook and the risk that it may pose to emerging markets as evident by further selling of South African bonds by foreign investors.

Global bond yields also ended higher in the quarter (WGBI -0.92%) - yields on 10 year bonds rising in all developed markets excluding New Zealand. The rising yields in these markets was in line with major central banks either raising interest rates (US, UK, and Canada) or becoming more hawkish in their communication to the market. While emerging market bond yields did end the month higher in line with developed market bonds, they still managed to record a positive return (0.38%) due to their approximately 3.3% higher yield.

The inflation-linked bond curve continued to drift higher during the quarter with shorter dated maturities rising by more than longer dated ones in a sign that investors are not overly concerned with a material increase in inflation over the near term.

The listed property sector remains a significant underperformer having recorded its 3rd consecutive negative quarter, this being the first time this has happened since 2004. The sector remains under pressure as economic growth continues to disappoint and the market being sceptical of companies' distribution policies and the ability to meet previous distribution growth expectations.

3. Portfolio activity

The Multi Income fund outperformed the bond market and the Stefi index for the quarter with a return of 1.71%, although due to the fund's duration position being slightly above neutral at 1.15, suffered marginally with the continual uptick of bond market yields. We continued to see value in bonds and increased our duration position to almost 1.3 during the quarter. We still favour fixed rate bonds over floating rate bonds and believe that the bond market is pricing in significant fiscal risk. On a real yield basis, longer dated fixed rate bonds are offering real yields in excess of 4%. The challenge is to not introduce too much interest rate risk into the fund whilst taking advantage of the steepness in the yield curve to keep the yield in the fund high.

With credit spreads continuing to narrow we are finding limited value in the credit market and are very much in favour of shortening our credit duration position. We will not be reinvesting extensively until we see better value in the credit market. On a risk adjusted basis we see better value in government bonds. The fund is positioned mainly in high quality credit with the banking sector still being our largest weight.

Listed property has continued to underperform and we reduced our exposure from 2.3% to 1.6% in the quarter. We have also reduced exposure to inflation linkers as we are not overly concerned with a material increase in inflation and are getting more attractive real yields from nominal bonds.

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Portfolio positioning

With credit spreads having narrowed and looking more expensive, we are now actively looking for ways to enhance yield in the fund, besides reinvesting in credit. We have increased our government bond exposure in the form of the R186 and are looking at various structuring opportunities to keep the fixed rate exposure and our current duration position while enhancing the yield on these exposures to over 10%. Due to the volatility in the bond market and the steepness of the curve, we are also seeing value in embedding options into notes which enable an enhanced yield above a vanilla credit spread. We are extremely cautious in the credit market as we are seeing most primary auctions clearing below guidance and not pricing in the credit risks appropriately. This has extended into the secondary market as many corporate bonds, particularly in the banking sector, have repriced and are looking expensive.

We will also remain cautious on the property sector and on a risk adjusted basis now do not believe that the sector is offering value. This is due to the fact that growth prospects for distributable income are extremely poor and are consistently being revised downwards. We are unlikely to upweight our property exposure, unless particular quality stocks have derated significantly. Inflation linked exposure in the fund will remain low in the fund as long as we believe nominals are compensating us more for inflation.

We will continue to keep the yield in the fund high while diversifying across different sectors and risk categories and being mindful of interest rate risk.

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. Bronwyn holds a B.Comm (Honours) degree from the University of Natal.

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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.