GRANATE ASSET MANAGEMENT

Part of RMI Investment Managers

QUARTERLY COMMENTARY – Q3 2018

Granate *SCI Unconstrained Fixed Interest Fund

Fund Profile

The Granate SCI Unconstrained Fixed Interest Fund is a domestic fixed interest portfolio which seeks to provide investors with exposure to the fixed interest market and aims to offer maximum returns by actively extracting value from various sources within the fixed interest universe. The portfolio uses strategic asset allocation, aggressive duration (ranging between the duration typical of a money market fund and the longest maturity South African government bond), yield curve positioning, switches, stock selection as well as derivative and other yield enhancement strategies, including exposure to foreign currency to maximize returns. The objective of the portfolio is to maximize both income and capital over a long-term investment horizon. Given that the portfolio aims to maximize total return (which includes capital) it is expected to be more volatile than a traditional income fund with the possibility of negative monthly returns. 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

During the 3rd quarter we continued to increase the portfolio's exposure to fixed rate bonds by 4% in the long end of the yield curve. To ensure that we maintain sufficient liquidity in the portfolio to allow us to change interest rate risk in line with the portfolio's objective of maximising both yield and capital return over time, we bought long dated government bonds using cash from maturing short dated floating rate notes and bank NCD's.

After reducing the portfolio's exposure to inflation-linked bonds towards the end of the 2nd quarter, we bought back the exposure in August as the inflation carry looked more attractive and it appeared that short dated nominal bonds and money market instruments were under estimating the near-term inflation risk. After the sell-off in nominal yields during the first part of September where the inflation-risk premium increased again, we switched out of some of the inflation-linked and into nominal government bonds.

We reduced the portfolio's exposure to the listed property sector by 1.2% during the quarter to 5%. The sector has performed very poorly and the spike in price volatility of certain stocks has made us more cautious of the sector. In particular, we lowered the portfolio's exposure to the foreign counters (Nepi Rockcastle, Hammerson, and Intu) as we think their benefits as a rand hedges have declined and we have also reduced exposure to stocks that have a relatively high exposure to the residential sector (SA Corp and Octadec).

4. Portfolio positioning

South Africa's economic growth remains well below its potential rate and is expected to improve, albeit gradually. The poor domestic growth is in stark contrast to global growth which continues its strong upswing. While the poor domestic economic growth has negative implications for the fiscus it also implies that inflation will remain generally contained.

Our bond valuation guide, which uses global risk free rates, South Africa's Sovereign risk and inflation as its inputs suggests that local bond yields are offering a positive *risk compensation*. Therefore, the fund continues to increase exposure to the long end of the yield curve (now 39% of the fund) at yields around 10% with an overall yield to maturity of 9.5%. The fund is currently using half of its interest rate risk "budget" (given the still material risks to yields that a shrinkage in global liquidity poses) and is keeping significant liquidity to allow for adjustments due to high volatility.

Given the poor economic outlook we keep the exposure to listed property significantly below its long term strategic asset allocation and have concentrated our holdings in high quality, less volatile stocks. Our decision not to cut exposure to the sector to zero stems from the fact that we think that the difficult environment is generally priced into the better-quality stocks and the yields they offer is attractive.

Like with property, the portfolio's exposure to inflation-linked bonds is materially below its long term strategic asset allocation. This is even though we think that at yields of around 3%, this asset class is offering positive *risk compensation* and is attractive in absolute terms. However, relative to nominal bonds, inflation-linked bonds appear expensive particularly at the long end of the yield curve.

Granate SCI Unconstrained Fixed Interest Fund – Portfolio Manager Profile

Jonathan Myerson (M.Soc.Sci. - Econ), MIFM

Prior to joining Granate Asset Management in December 2015, Jonathan served as the Head of the Fixed Interest team at Cadiz Asset Management from 2006 to 2015 where he managed the Unconstrained, House View and Inflation-Linked Bond funds. Jonathan has 11 years of sell-side experience having worked as a Fixed Interest Strategist at HSBC from 1995 to 2003 and then at RMB from 2003 to 2006. Jonathan holds an M.Soc.Sci. (Economics) from the University of Cape Town.

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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.