GRANATE ASSET MANAGEMENT

Part of RMI Investment Managers

QUARTERLY COMMENTARY – Q4 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 has slowed down marginally in the 4th quarter but remains on track to match last year's robust performance. Whilst consensus forecast is for a continuation of the economic upcycle, there are signs that the risks of a US recession (with broader global implications) is growing. Similar (low) rates of unemployment and yield curve shape have historically been followed by recessions.

Domestic economic growth in the 3rd quarter of 2018 (released during Q4 2018) rebounded to a seasonally adjusted quarter-on-quarter annualised (q/q) rate of 2.2% from an upward revised -0.4% 2nd quarter growth rate. The positive outcome means that the economy has emerged from its brief recession. The strong rebound was predominantly due to a strong performance of the manufacturing sector (making up 13.5% of GDP) which recorded its strongest 3rd quarter (7.5%) in over a decade and despite a poor performance of the mining sector (-8.8%) (that makes up only 8.1% of GDP). Concerningly, gross fixed capital formation declined by a q/q rate of 5.1%, its 10th negative quarter in the last 12 quarters. High frequency economic data releases for the 4th quarter have surprised on the upside and suggest that the economy continued to grow in 4Q although, judging from the still weak confidence and PMI surveys, momentum remains subdued.

The Monetary Policy Committee (MPC) of the Reserve Bank met once in the 4th quarter and increased the repo rate by 25bps to 6.75% - the first hike since Feb 2016, in a close decision (3:3 vote). While the rate hike was broadly in line with the SARB's Quarterly Projection Model, communicating the decision was made difficult by a much stronger rand and lower oil price since the previous meeting. Furthermore, the MPC's inflation and GDP growth forecasts were lowered, implying less justification for a hike. Therefore, we think that the decision by the SARB should be seen as a further sign that the MPC is focused on the midpoint (4.5%) as the inflation target rather than the 3%-6% range.

We maintain our view that barring a sell-off in the rand or a rally in oil, the SARB is likely to keep the repo rate unchanged in January 2019 before hiking again in March 2019, but global developments could mean a delay in the next hike.

2. Market overview

Financial markets ended the year on shaky ground. Locally, money market outperformed all other domestic asset classes both for the quarter and the year. Adjusted for inflation, only bonds and money market recorded positive returns over the last 1, 3, and 5 years. Given the make-up of domestic pension funds (with their heavy weighting towards equities), real value of retirement saving has, at best, remained unchanged over the last 5 years and in many cases, would have declined.

Money market rates continued their upward trend in the 4th quarter of 2018. The 3-month Negotiable Certificates of Deposit (NCD) rate ended the quarter 17.5 bps higher at 7.125%, while the 12-month NCD rate ended 2.5bps higher at 8.325% (Q3: 8.3%). The large movement in the 3-month NCD was largely due to the rate hike that occurred during the quarter. Money market rates were less volatile that the previous quarter with the 12-month NCD trading in a 12.5-basis point range as compared with the 40-basis point range seen in the previous quarter.

The money market curve flattened during the quarter despite the weaker currency as both economic growth and inflation remain subdued. The gap between what the market is pricing in for the repo rate path and the SARB's Quarterly Projected Model (QPM) continued to widen – the market pricing a 25bps hike by the end of 2019 compared with the QPM's 50bps.

3. Portfolio activity

We started the 4th quarter\ with a higher exposure to longer term floating rate money market assets. This strategy was appropriate as Jibar rates increased post the rate hike and funding rates remained attractive. Thus, the portfolio benefitted by holding these higher yielding assets.

The money market curve continued to price in multiple repo rate hikes and our valuation models indicated that the longer term fixed rate money market instruments offered significant positive risk compensation. We therefore invested with a bias towards longer duration fixed rate assets.

4. Portfolio positioning

Currently the portfolio has a higher exposure to floating rate bank paper. Given the high probability of a repo-rate increase in 2019, floating rate notes will benefit if the reserve bank increases the repo-rate at future meetings. The risk is fewer or no further rate increases because of the absence of demand-pull inflation and potential global developments, but with Jibar and funding rates being abnormally high, the portfolio will benefit by holding these instruments.

We will however continue to follow our valuation models and invest cash holdings into the longer term fixed rate assets which are currently offering positive risk compensation.

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)

Vaneshen 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.