QUARTERLY COMMENTARY – Q4 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 has slowed down marginally in the 4th quarter but remains on track to match last year's robust performance. While consensus forecast is for a continuation of the economic upcycle there are signs that the risks of a US recession (with boarder 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. 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.

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.

The bond market returned a respectable 2.7% in the 4th quarter as bond yields (R186) traded in a 50 basis point (bp) range and ended the quarter practically where is started. The long end of the yield curve (R2048), however, was only 2bp lower implying a slight decline in value. The reasonable performance of bonds came with a significant bout of volatility. November (+3.9%) was a stand-out month where the bond market was supported by a strong rand (+6.6%) which benefited from improving terms of trade and a generally supportive global environment, as evident from the strong performance of both EM bonds and equities, that saw foreign investors returning as net buyers (+R2.6bn) to the local market for the first time since July. Taking global markets performance in the 4th quarter into account, South African bonds have held up well – a function of the attractive prospective real yields that they are trading at.

Global economic uncertainty impacted financial markets in the 4th quarter more than it did in the 3rd as evident from the worst quarterly performance in 10 years of key equity indices such as the S&P500 and a spike in the VIX index. This sent investors to the safe haven of developed market bonds driving all key market rates lower with the yield on the 10yr US Treasury declining by 36bp, this despite the US Fed raising its key lending rate by 25bp. Despite the increase in risk aversion emerging markets fared well outperforming all major asset classes.

Inflation-linked bonds continue to perform poorly as inflation, while likely to remain around current levels for the next few months, is not expected to rise rapidly and does not appear to pose a major, hence investors are not seeking inflation protection which this asset class offers.

The listed property sector remains a significant underperformer having recorded its 4th consecutive negative quarter and its 10th negative month of the year in December. The sector has come under growing scrutiny due to allegations of inaccurate financial reporting by some of the larger companies. Furthermore, results and trading update point to very tough trading conditions as also evident by the risk that Edcon (a substantial tenant in most retail shopping centres) may not meet its rental obligations.

3. Portfolio activity

The Multi Income fund outperformed the the Stefi index for the quarter with a return of 2.3%, with the highest duration position during the quarter being around 1.25, and ending the quarter at a duration of 0.88. The fund remained true to its objectives of keeping duration below 2 at all times and focusing mainly on yield enhancement. We are saw bond valuation models move into expensive territory towards the end of November and hence cut our duration position. Fixed rate bonds are now only 18% of the fund with the rest of the fund being made up of floating rate bonds and cash. We sold down our government bond position and invested in 1 year NCDs as we are finding the NCD curve relatively flat post 1 year. On a real yield basis, longer dated fixed rate bonds are offering real yields in excess of 4%, which is attractive . The challenge is to not introduce too much interest rate risk into the fund whilst there are significant fiscal risks on the horizon with the potential for government bond yields to move higher.

Credit spreads continued to narrow during the quarter and we are finding limited value in the credit market and we have shortened our credit duration position considerably. We will not be reinvesting extensively until we see better value in the credit market. The fund is positioned 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 1.6% to 1.2% in the quarter, selling our exposure to UK property stocks as we became concerned around the risks around the Brexit fallout. 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.

Portfolio positioning

With credit spreads having narrowed and looking more expensive, we are not finding value in the credit market. We have reduced our government bond exposure in the form of the R186 as bonds have become more expensive. The burning question for 2019 is where will we find yield if not in the credit space? For now we are comfortable maintaining a larger percentage in money market instruments in the fund as we believe the these instruments are offering value on a relative basis to credit, and will look for opportunities as credit spreads begin to widen.

We will also remain cautious on the property sector and only hold the high quality and less volatile stocks. We believe that the negative environment is generally priced into these better quality stocks and the yields on these stocks are attractive. We are unlikely to upweight our property exposure in the near term, unless particular quality stocks have derated significantly. Inflation linked exposure in the fund will remain low in the fund as long as we believe nominal bonds are compensating us more for inflation.

The fund is very defensively positioned and we are likely to maintain this stance in the near term. We will continue to focus on maximising yield in the investment grade space 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.