Quarterly Insights – August 2017

from our Investment Management Team

Hollard investments

In this note we summarise the three dimensions of capital markets insights that guide our tactical asset allocation decision process, namely: Regime, Returns and Risk.

We then explain how we have translated those insights into Relative-positioning decisions for our Hollard Prime Defensive, Balanced and Assertive Funds of Funds.

Regime dimension

Global capital is likely to continue to flow towards emerging market economies from developed market economies, supported by:

- Higher anticipated growth rates – The IMF's projections for growth in emerging market economies (2016: 4.3%, 2017: 4.6%, 2018: 4.8%) are higher than those of developed market economies (2016: 1.7%, 2017: 2.0%, 2018: 1.9%). Growth is also broadening across developed market economies which promotes increased trade flow from emerging market economies (i.e. exports) to developed market economies

- Shrinking but still significant inflation differentials in the aggregate - Inflation in most developed market economies remain low and generally below their respective central bank targets. Most emerging market economies' inflation outlooks have significantly improved. The latter provides support for stable currency exchange rates in emerging market economies

- Higher interest rates in emerging market economies which promotes carry trade - Low inflationary pressures in developed market economies is supportive of an expansionary monetary policy stance, hence we can expect the tightening cycle to be slower and interest rates to remain lower for longer. As a result, the global search for yield is likely to continue

The near to medium term risks to the above narrative which could trigger a risk-off sentiment and a reversal in capital flows out of emerging markets into safe haven (developed market) assets are:

- Potential spike in volatility levels – market volatility (as measured by the VIX) are currently at unusually low levels
- Much faster than expected monetary policy tightening in some developed economies
- Rising policy uncertainty i.e. US fiscal policies, negotiations of post-Brexit arrangements and/or geopolitical risks
- Country specific risks of emerging market economies

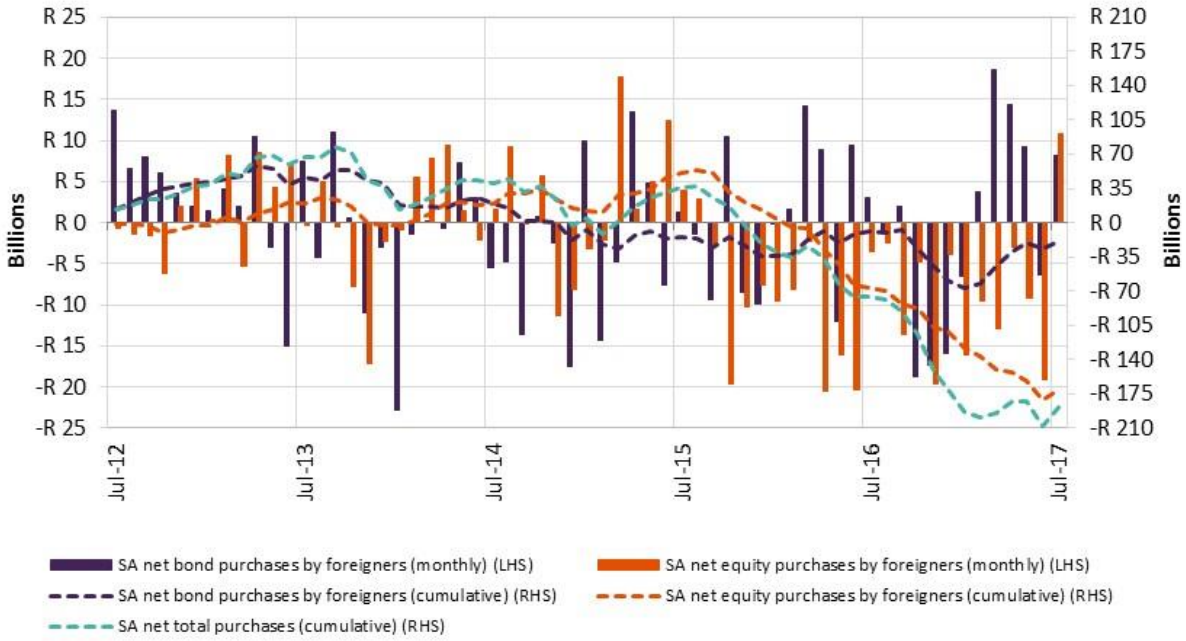
We evaluate these risks in aggregate to be of medium probability over at least the next 6 months, and expect a fairly high impact should they occur. We will continuously monitor them pending our next review in November.

Locally, SA being an emerging market economy is likely to benefit from the carry trade, hence potential for flows into SA's fixed income market. However, there are significant SA-specific imminent risks which could deter and potentially lead to capital outflows. They are as follows:

- SA's unstable political environment puts both the rand and SA's credit rating at risk. If SA's local currency debt gets downgraded by just one notch by one of the credit rating agencies, it would trigger a removal of SA from international bond indices. The impact of this is significant and could lead to outflows from SA's fixed income market in the range of R80bn – R130bn

- The level of interest rates in SA is low relative to other emerging market economies (SA: 6.75%, Turkey: 11.95%, Brazil: 9%, Russia: 10.25%), making SA a relatively less attractive destination for carry trade. Further interest rate cuts by the SARB in an attempt to provide some support to the weak SA growth could further decrease SA's relative attractiveness and dampen foreign bond flows

Figure 1: Net assets purchased by foreigners



In summary, globally the Regime dimension would suggest overweight exposures to growth assets such as equities but more in favor of emerging market equities than developed market equities. Amongst income assets, overweight exposures to emerging market economies fixed income and underweight exposures to developed market economies fixed income as yields are likely to remain unattractively low.

As a South African investor, the regime dimension would suggest overweight exposures to global assets in general and underweight exposures to SA growth assets

Returns dimension

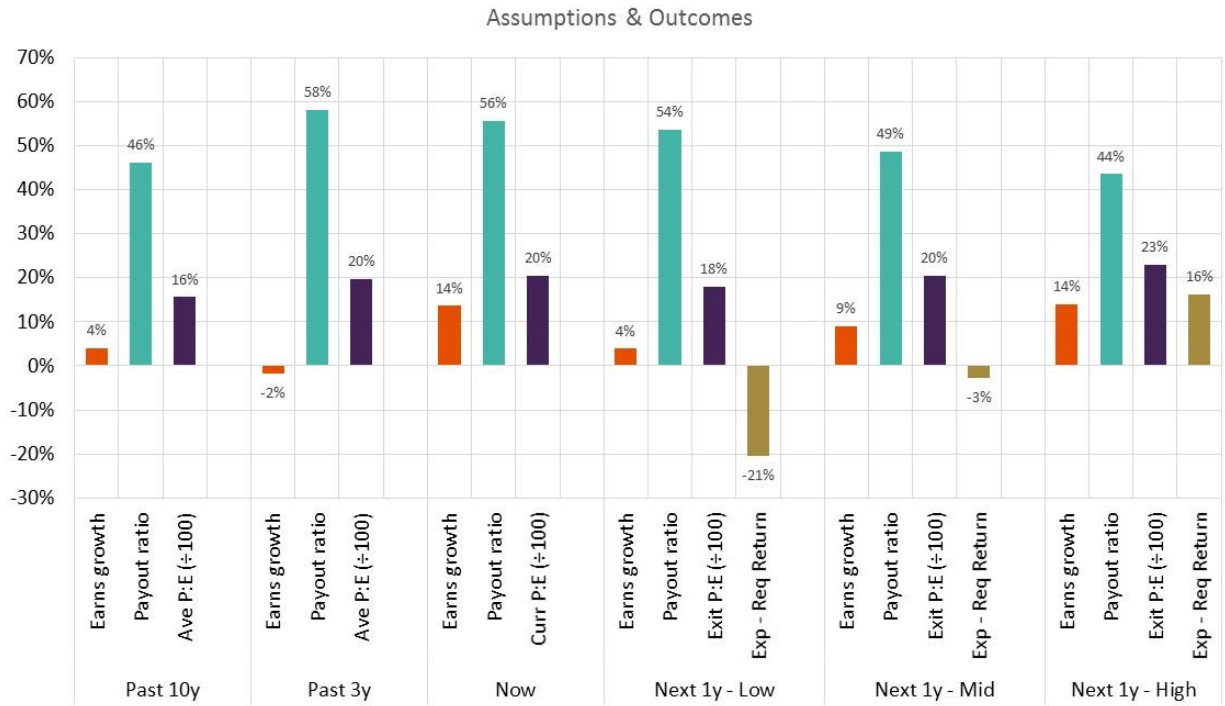
Growth assets

Our forward-looking and scenario-based valuations model suggests that our mid-road expected return scenario for SA equities offers some downside relative to returns required to compensate for the risk inherent in the asset class.

On the other hand, SA listed property, developed markets equites and developed markets listed property all appear to offer some upside relative to the respective required returns for each of these asset classes.

We believe that our low-road scenario is more likely to materialise than our high-road scenario, suggesting ongoing caution particularly about SA and US equities.

Figure 2: SA equity valuations – low, mid and high road scenarios



Based on our mid-road scenario, emerging market equities appear attractively priced. This suggests that there is some up-side relative to our required return for this asset class. Our view is that the recessionary conditions experienced by emerging markets in the last few quarters have largely abated following a rally in commodity prices between late 2016 and early 2017.

Our over-weight allocation of capital to emerging markets equities remains on a broadly-diversified indexed basis, as we have in developed markets.

The mid-road scenarios for both SA and developed markets listed property show that they are somewhat fairly valued to expensive. However, their expected earnings distribution growth rates remain comfortably above SA and developed markets economic growth, respectively.

Despite the somewhat favorable valuation for SA property, we are concerned about the headwinds facing the SA retail sector (i.e. excess supply in a weak SA economy, low consumer and business confidence levels, negative trading density growth) which makes up 51% of the SA listed property index.

Income assets

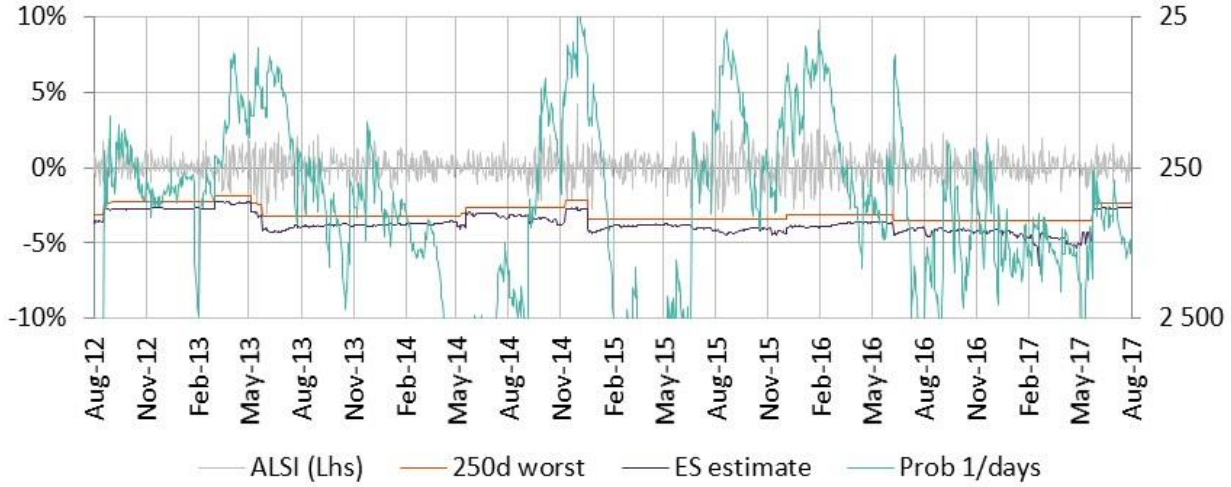
US 10-year government bonds are expensive, whilst SA short-term bonds and cash appear fairly and attractively priced, respectively, in all cases assuming that anticipated rate moves are not yet fully priced in.

Risk dimension

Our proprietary risk models measure the following short term risks for the SA equity and other markets: the current probability and possible extent of extreme downside events, and the build-up and dissipation of these downside risks over time.

These models show that the market is pricing-in a "less-than normal" downside risk for SA equities, which is a signal of perceived "below average" SA equity risk. In other words, local investors are pursuing a risk-on trade in the short-term. While this is currently encouraging, we remain cautious due to the stretched valuation factors referred to under "Returns dimension" above.

Figure 3: SA equity risks – probabilities of a new 250-day worst loss



Relative positioning

On the basis of the above three dimensions of insights, we have made the following tactical asset allocation changes across our Hollard Prime Defensive, Balanced and Assertive Funds of Funds.

Relative to each Fund of Fund's strategic positioning (i.e. sector average asset allocations), we have:

Growth assets

↔ kept exposure to SA equity unchanged at an underweight of -2.5%

↔ kept exposure to developed markets equity unchanged at an underweight of -2.5%

↔ kept exposure to emerging markets equity unchanged at an overweight of +5%

↓ decreased exposure to SA markets listed property from an overweight of +2.5% to neutral

↔ kept exposure to developed markets listed property unchanged at neutral

Income assets

↔ kept exposure to SA cash unchanged at a large underweight, and to balance this…

↑ increased exposure to SA bonds (short duration) to a large overweight

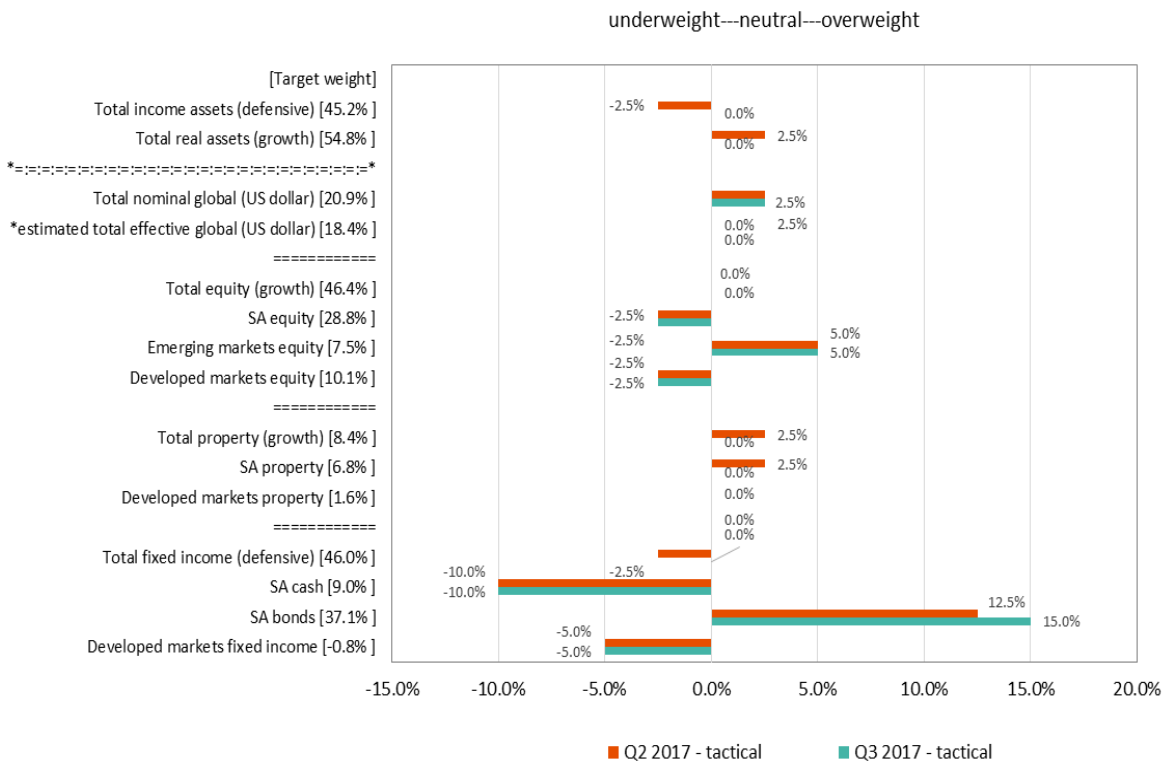
↔ kept exposure to developed markets fixed income unchanged at an underweight of -5%

Note: income assets exposure continues to be taken exclusively through SA multi-asset income strategy which focuses on maximising yield from instruments with a low effective duration and high credit quality.

Currency

↔ kept nominal exposure to US dollar-denominated assets at an overweight of +2.5%
(an estimated neutral effective exposure)

Figure 4: Asset class allocations – Hollard Prime Strategic Balanced Fund of Funds



The Hollard Investments - Investment Management Team is:

Ashveena Khusial
BBusSc (Hons) CFA CAIA
Fund Management

David R Green
BA LLB CFA MBA
Investment strategy

Conlias Mancuveni
BCom (Hons) MSc MBA FRM
Asset class allocations

Tshegofatso Pule
BSC (Actuarial) FRM
Evaluation & Modelling