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How to mitigate downside risk and benefit from upside performance – making smart investment choices

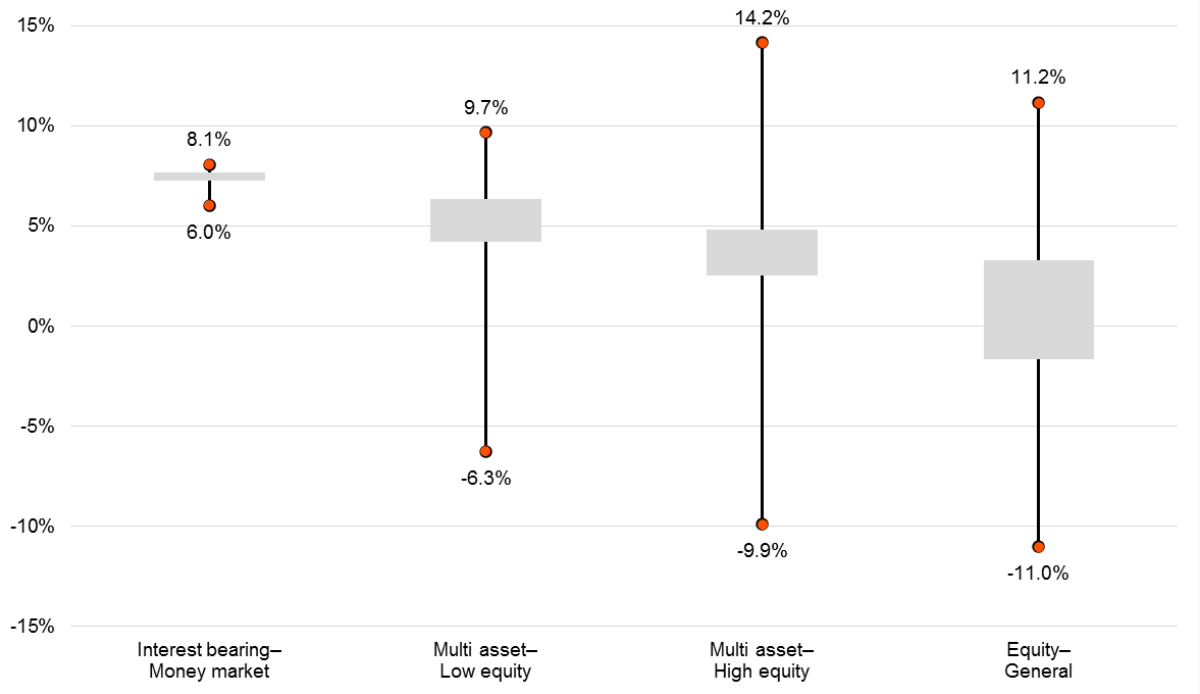
Written by: Madalet Sessions, Portfolio Manager at Denker Capital

A deep dive into the three-year performance numbers of four popular ASISA categories shows how wide the range of returns available to investors can be. To limit the risk of significant capital losses and benefit from the return, potential investors must consider the range of outcomes available and the factors that determine them: asset allocation; the fund manager's investment philosophy and process; the manager's approach to risk management; and the investment time horizon.

The range of returns offered by South African markets is wide, which emphasises the importance of making informed investment decisions.

In Figure 1, the grey boxes represent the range of returns delivered by all the funds in the second and third quartiles per ASISA's South African fund category for the three years to 30 June 2020. The lines extending upwards and downwards represent the range of returns produced by the top and bottom quartile funds. This shows that, while the range of returns offered by funds in the second and third quartiles of a specific fund category is quite narrow, the range of upside and downside is wide.

Figure 1: Annualised fund performance over three years to 30 June 2020 by ASISA category



Source: Morningstar and Denker Capital, 30 June 2020

Although Figure 1 does not take into account different fund mandates, investment benchmarks or objectives – all of which are partially responsible for some of the observed differences in returns – it illustrates how important it is to make the right asset allocation decisions and to invest with the right fund managers.

A. Interest Bearing – Money Market portfolios

A skilled fund manager can create additional returns above the short-term interest rates in the economy, but the scope for higher returns is limited.

Over the last three years, the best-performing money market fund delivered an annualised return of 8.1% while the worst-performing fund delivered a return of 6.0%. The range of returns for the second and third quartile funds varied only slightly, from 7.3% to 7.7%. It's important to note that the absence of an adverse credit event over this period, such as the collapse of African Bank in 2014, could have influenced this outcome.

On the face of it, fund manager selection therefore does not seem to make a substantial difference to returns earned in this category. This is because the most important determinant of returns is the level of short-term interest rates in the economy. Given the limited ability to earn returns that differ substantially from the prevailing interest rate, it is important that investors understand the risk management processes of their chosen fund manager. An appropriate risk management framework will help prevent unexpected capital losses in the case of an adverse credit event (although these events are difficult to assess, given that they are limited). The most important risk management tool for a money market manager is not to have excessive exposure to one issuer. Managing the size of the exposure limits the potential for capital losses should an issuer fail.

B. Multi Asset – Low Equity portfolios

Avoiding the riskiest fund manager strategies will give investors the capital stability they seek and help prevent unnecessary capital losses.

Although the range of returns for the majority of funds in this category is quite narrow (returns from the bottom of the third quartile and top of the second quartile ranged from 4.2% to 6.4%), there is a more substantial difference between the top-performing fund and the worst-performing fund over the three-year period. The worst to best annualised returns in this category varied from -6.3% to 9.7%. To put this into perspective, investors who earned an annualised return of -6.3% over three years in this low-risk category would have lost nearly 20% of their capital over the period. Investors who require capital stability must therefore be careful to choose funds that won't expose them to the risk of such significant capital losses.

To make an informed decision, investors can look at the following:

1. Do risk management and capital protection form part of the fund manager's investment philosophy and the fund mandate, or is there a singular focus on return?
2. How has the fund/portfolio manager performed during previous market downturns? What capital losses did investors sustain?
3. Check the asset allocation and holdings information on the minimum disclosure document (MDD). Is the fund well diversified or are returns reliant on one or two significantly weighted holdings?

So, even though it is relatively difficult to earn returns that vary greatly from those of the peers in this category, since the amount of risk exposure is constrained to provide capital stability, investors are still at risk of capital losses when their fund managers do not take the necessary precautions and diversify.

C. Multi Asset – High Equity portfolios

Short-term underperformance is inevitable for active managers, so understanding the fund manager's investment process and philosophy is critical to optimising long-term returns.

As with the low equity category, the annualised returns generated by the second and the third quartile funds fell in a relatively tight band of between 2.5% and 4.8%. Returns for the category overall ranged from -9.9% to 14.2%.

Active investors will be subject to a wider range of outcomes than those who stick closely to the benchmark. While benchmark hugging may not result in significant disappointments, it also reduces the potential for substantial outperformance over the long term. The ability to generate alpha is determined by a consistent application of a proven investment philosophy and process. Alpha, unfortunately, does not accrue smoothly in fund returns. Fund managers can only generate alpha by increasing the risk of generating poor returns compared to benchmarks or peers *in the short term*. One can only share in the returns generated by the underlying funds over time if one remains invested over time. That's why it is critical for investors to understand the investment process and philosophy of their fund manager.

Investors who choose to invest with an active fund manager in this category must understand what they own. If they don't, they may be prone to dis-invest during times of short-term underperformance, which means they will miss out on the superior long-term returns. This requires that investors understand whether the fund manager's philosophy enables them to deliver alpha, and whether the investment process supports the consistent application of the philosophy. For investors who are not comfortable with assessing the investment philosophy and process of a fund manager, it may be better to invest in a passive fund, where performance shocks are less likely, or to spread their capital between several reputable managers who have consistently proven the effectiveness of their philosophy and investment process over many years.

D. Equity – General portfolios

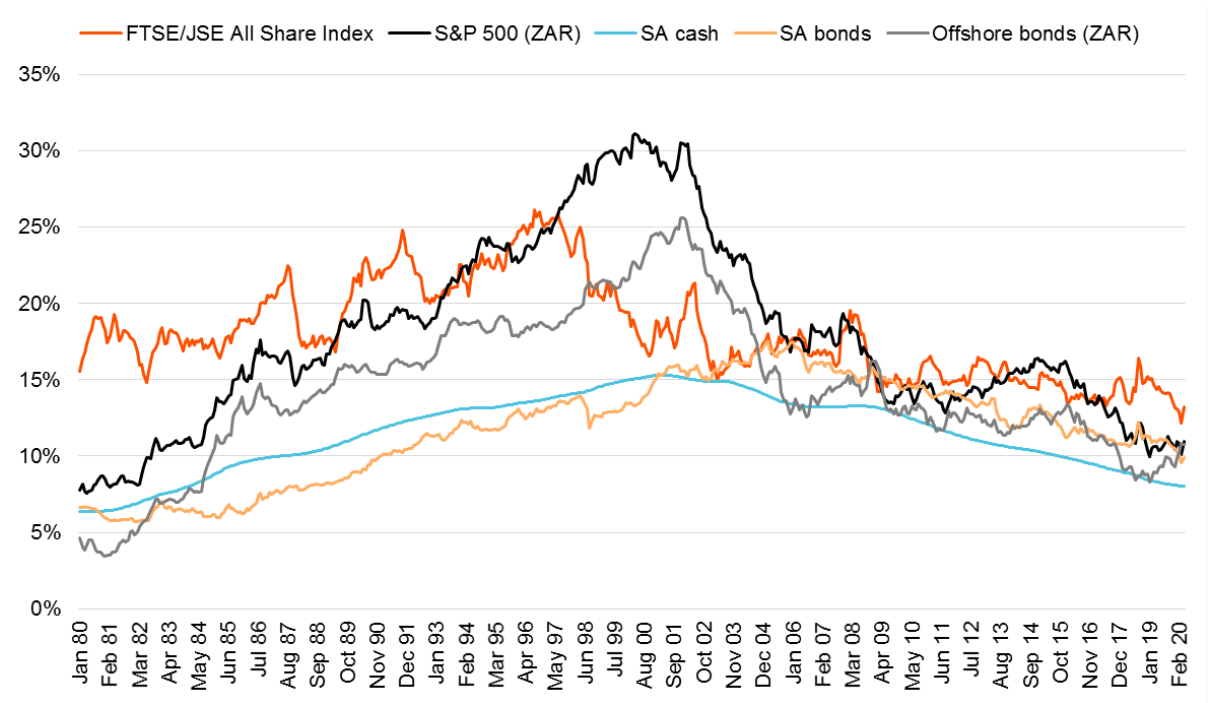
As with high equity portfolios, fund manager selection is critical to smooth out performance.

While equity investment decisions should not be made based on short-term performance, we included the general equity category in Figure 1 for illustrative purposes. The worst-performing general equity fund delivered an annualised return of -11.0% and the best earned 11.2% (which is less than the 14.2% generated by the best-performing multi asset high equity fund). The range of returns for the second and third quartile funds was quite narrow at -1.6% to 3.3%.

As with high equity portfolios, equity market returns and the underlying equity philosophy and process of the fund manager are important determinants of returns.

The last few years have been particularly tough for South African equity investors as returns have been disappointing. Although there are no guarantees that equity market returns will improve, history teaches us that over time investors have been rewarded for bearing this risk – as shown in Figure 2 below. Over most 20-year periods, the S&P 500 (in rands) and the FTSE/JSE All Share Index (ALSI) turned out to be the best-performing asset classes more often than not. Investors unwilling to accept equity risk will have to make substantially higher contributions to their investments to achieve their desired outcomes, as returns from other asset classes are unlikely to match those of equity markets in the long run.

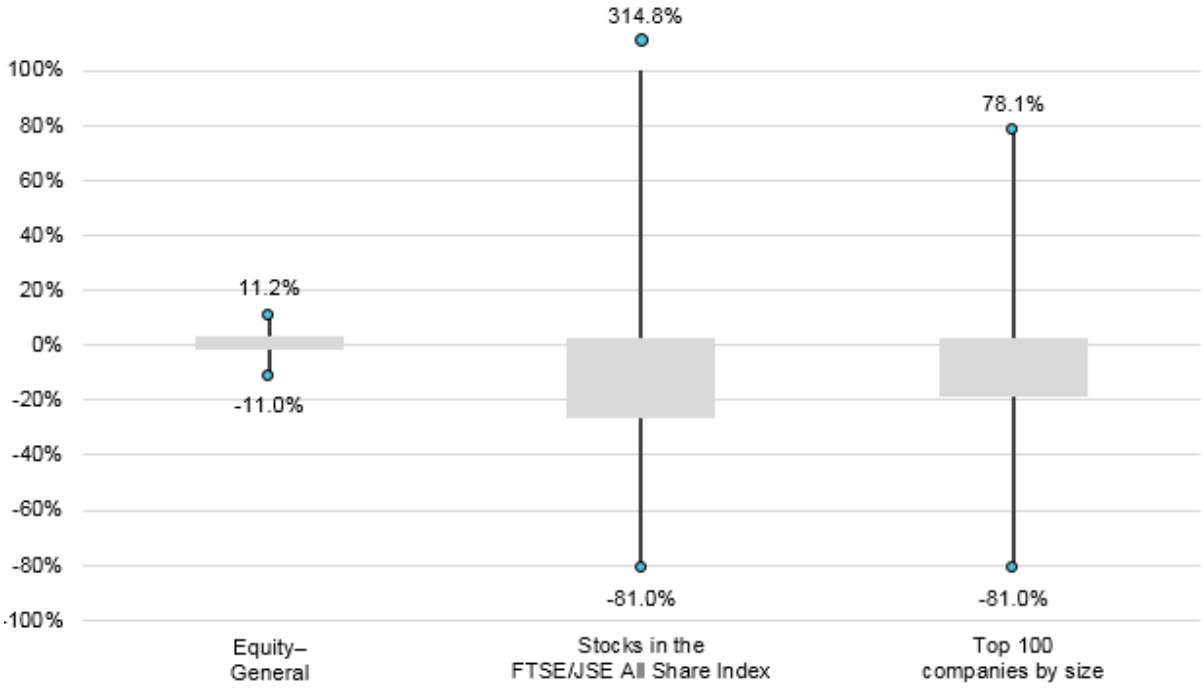
Figure 2: Monthly 20-year returns since 1980 show that equities have provided the best returns



Source: ThomsonReuters, JSE and Denker Capital, 30 April 2020

In Figure 3, using the same chart format we've used in Figure 1, we show the Equity – General category, the shares listed on the ALSI, and the largest 100 companies in ALSI. The chart is truncated at the top as one small gold company generated compound annualised returns of 314.8% over the three years to 30 June 2020.

Figure 3: Annualised fund performance over three years to 30 June 2020 of the Asisa SA Equity – General category versus shares listed on the JSE



Source: Morningstar, FactSet and Denker Capital. 30 June 2020

Taking a detailed look at the data used in Figure 3 we can make the following observations:

- Investors throwing darts at stock tickers are unlikely to beat the market when the market return is determined by a few heavy weights *and* a significant portion of the market has declined in value.
- 75% of the ALSI's constituents returned less than 2.6%. Implicit in this outcome is that a few large companies (with heavy weights in the index) were responsible for most of the index's return. The index itself gained 5.1% annualised over this time. An equally weighted portfolio of the largest 100 companies would have declined in value.
- South African general equity funds are quite diversified, as can be seen from the much narrower range of returns, and have, on average, earned better returns than what was available from the underlying equities. This suggests that these funds are invested in large companies at the expense of smaller South African companies.
- Although there are smaller companies that have delivered better returns than some of the larger companies, they have, on average, delivered worse returns. This is evident from the grey box showing the range of returns for the largest 100 companies being smaller than the ALSI grey box, and the ALSI's box extending lower down.

Generally, it is not widely appreciated how resilient markets have been or how well fund managers have done under these tough circumstances – 25% of the shares included in the ALSI have lost more than 60% of their equity value over this period.

It's critical for investors to consider asset allocation, the expertise of the fund manager, and their investment time horizon if they want to minimise risk and optimise their returns.

Being invested in the wrong funds fundamentally compromises investors' ability to meet their investment objectives. It's therefore vital for investors to first look at the asset allocation or fund category of the fund they want to invest in, together with considering how long they want to stay invested. Investors who cannot tolerate capital losses, for example, should ensure they invest in funds with low to no exposure to equity markets. Equities, on the other hand, are very volatile but offer attractive capital growth potential over time, which is why they are suitable for long-term investors. Once investors know which asset allocation is suitable for them, understanding the fund manager's investment process, philosophy and approach to risk management is as important as making the right fund choice to help them meet their objectives.

Glacier Research would like to thank Madalet Sessions for her contribution to this week's Funds on Friday.

Madalet Sessions

Portfolio Manager at Denker Capital

Madalet co-manages the Denker SCI Balanced Fund and Denker Sanlam Collective Investments (SCI) Stable Fund with Jan Meintjes. The Denker SCI Balanced Fund is managed using a combination of ideas to offset risk and provide more consistent returns for investors. Investors in the Fund have exposure to a breadth of stock ideas for an unpredictable future. The Denker SCI Stable Fund aims to protect real capital over the medium term while providing a regular, tax-efficient income to investors who require it. The Fund owns its equity exposure passively (through indices) and is actively risk-managed to provide capital stability.

Madalet started her investment career at Investec Securities as a research assistant to top-rated investment strategist Brian Kantor. In 2008, she joined Element Investment Managers as an analyst responsible for fixed income, money market and property investments. From there, she moved on to Nedgroup Investments in 2010, where she was responsible for managing the Nedgroup Private Wealth Bond and Property Funds. She joined Denker Capital in 2016 to establish the business' range of multi-asset class funds.