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Outsized returns are wonderful, but don't risk the investment objective

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We are currently in an environment where longer-end SA government bonds yield higher than 11%. Investors see this as a great opportunity for return but there is the risk for income fund investors being distracted by the yields available at the risk of achieving their return objectives.

The primary focus of income funds is to beat inflation. They need to do this in a way that minimises the risk of underperforming over a reasonable (one-year) time frame. Income fund investors see income funds as a great place to earn real returns with low volatility. Historically, with higher interest rates than inflation (Chart 1 below) they have achieved these objectives. The last 18 months is one of the exceptions as interest rate increases lagged higher inflation.

Investors could be looking at 3% real returns in very low volatility assets going forward, which should make investors question how much risk they need to take to achieve higher returns. Other asset classes may produce higher returns but with much greater risk. (This against a backdrop of higher interest rates producing less liquidity and likely higher volatility).

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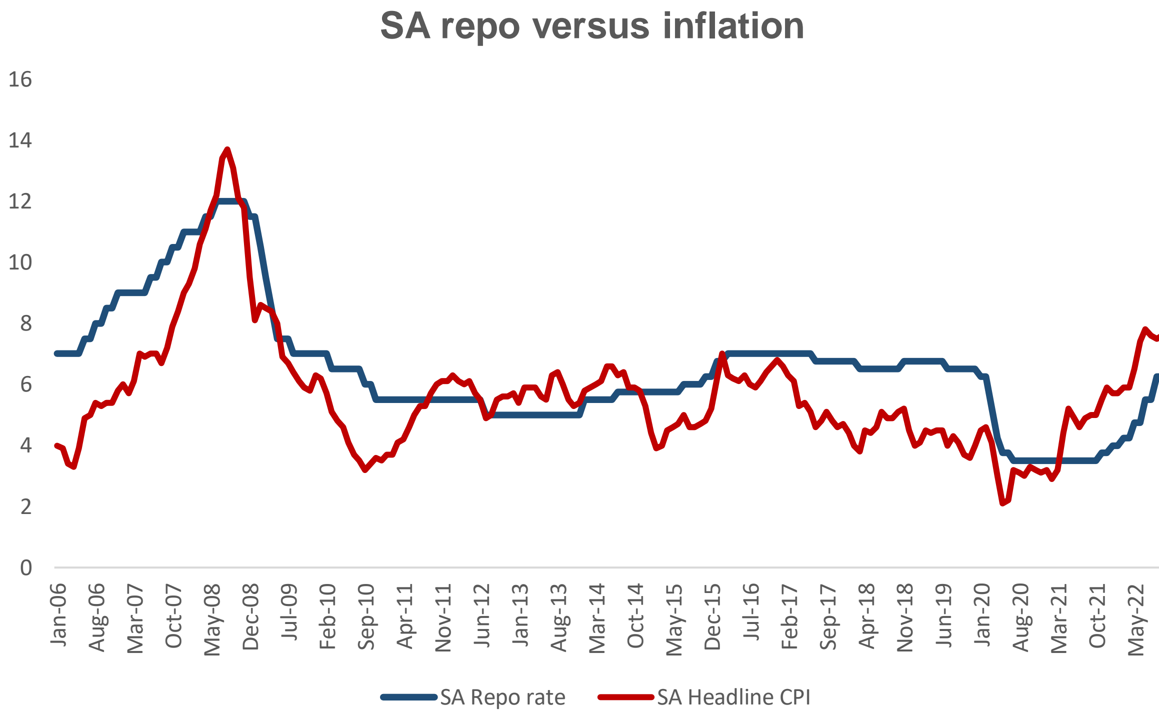
Chart 1. SA CPI versus the repo rate



Source: Methodical/Bloomberg

For years, income managers have told investors to move assets from money market funds into the more flexible and therefore hopefully higher-returning multi-asset income funds. This makes sense as the money market funds are highly constrained by the regulations and multi-asset income funds have a broad array of yield-producing assets in which they can invest (money market, bonds, credit, property, prefs, offshore etc.). These assets, however, do come with higher volatility. This is not to argue that volatility is a problem in itself, but where the investment horizon is shorter, it needs to be considered. It also doesn't make sense to invest in a highly volatile asset class without being compensated for its so-called 'return free risk'.

It appears likely that we are no longer in the same interest rate regime that we lived through after the global financial crisis (for many investors, their whole investment career). Developed world interest rates led by the US Fed are likely to be more positive and in the case of the Fed, real rates are likely to be 1% to 2% real over the longer term. All this means is that countries that require international financing (current account deficit) and are considered higher risk (budget deficit) will need to maintain an even higher longer-term real rate.

That's great news for savers. It is likely that we return to the days before the global financial crisis when cash gave returns above inflation. Unlike those times, however, South African inflation could continue to be sticky at higher levels, especially given the global inflation picture and capacity constraints that we face as a country.

Where does this leave income investors?

The objectives for an income fund investor are to beat inflation and the good news is that having emerged from a period where inflation significantly outperformed cash, we are now likely to go into a more favourable real-return environment, where income funds outperform inflation by 2% to 3%.

This is in sharp contrast to the last 18 months where inflation has outperformed income fund managers because of extremely negative real rates post-COVID and a resurgence of inflation.

Is it all good news for income investors?

For the most part, yes. However, income fund managers have to be disciplined in managing their funds to meet their clients' objectives. While longer-term bonds show the promise of higher returns and yields, they carry higher risk and put those objectives at risk. Fund managers should consider whether they need to go up the risk spectrum to achieve their investors goals.

What are the current opportunities?

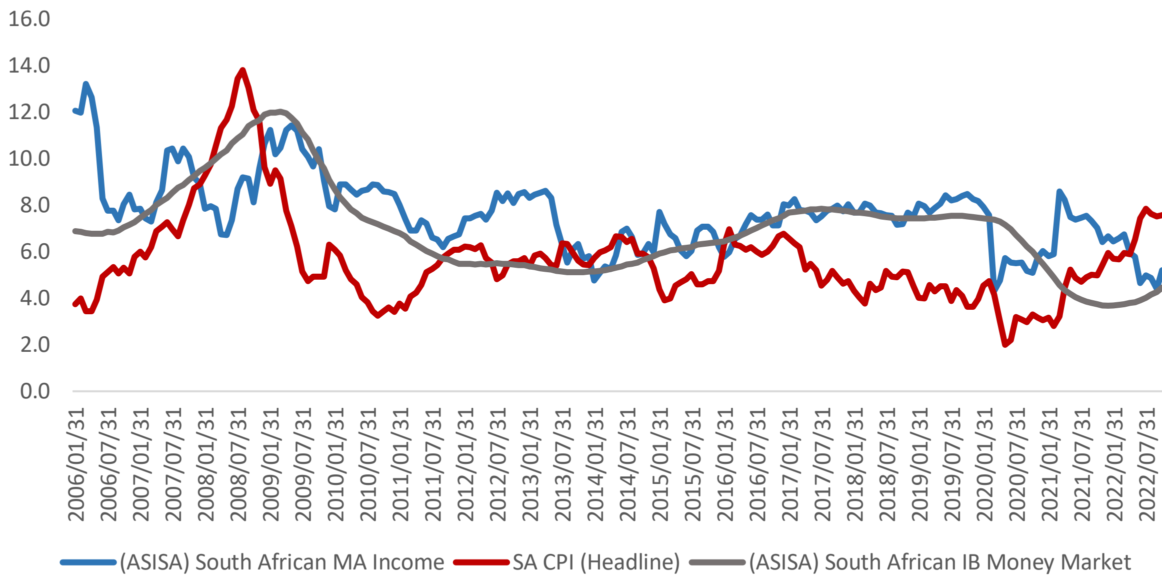
Currently a two-year government inflation-linked bond gives you a yield of 3.5% over-and-above inflation. The income investor can effectively immunise their risk of underperforming inflation by buying these bonds. The returns can be significantly higher from buying fixed bonds at yields above 10% if inflation reduces from the currently high level of 7.6%. The risk to income investors is that it stays at these levels and the bond curve weakens from here.

The point is not that we expect inflation to stay up here at the current high level or to get worse, but rather that investors don't need to take the risk in order to make the real returns that they wish to achieve.

Conclusion

When the SA repo rate was at historical lows in 2020, after being cut during COVID, income funds outperformed in the recovery (as shown in Chart 2 below). However, as we saw the increase inflation and the resulting tightening in global financial conditions, income funds struggled to protect the investor from the increase in inflation. A large number of interest rate increases to hike the repo rate to 7% means the degree of underperformance we have seen is unlikely but real returns could continue to disappoint if inflation stays high. Your income fund manager needs to continue to remain focused on their objective. I know that I will.

Chart 2. Performance of multi-asset income funds versus money market funds and inflation



Source: Methodical/Morningstar

Glacier Research would like to thank Jean-Pierre du Plessis for his contribution to this week's *Funds on Friday*

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