FUNDS ON FRIDAY
by Glacier Research

glacier
by Sanlam

17 November 2023
Volume 1207

Portfolio construction and adaptions in an ever-changing investment environment

Author: Melville du Plessis, Portfolio Manager, Sanlam Investments

The market moves and valuation shifts over the past few years have significantly changed the risk-reward equations for asset classes across the board. Those making investment decisions these days may even feel they are doing so in a new paradigm. But if you consider the history of financial markets, you quickly realise that the more things change, the more they stay the same.

Glacier Financial Solutions (Pty) Ltd, I A member of the Sanlam Group | Private Bag X5 I Tyger Valley 7536 I Email: client.services@glacier.co.za | Tel +27 21 917 9002 I Fax +27 21 947 9210 I Web www.glacier.co.za | Reg No 1999/025360/07 I Licensed Financial Services Provider
Glacier Management Company (RF) (Pty) Ltd is a registered and approved Manager in Collective Investment Schemes

This document is intended for use by intermediaries. The information contained in this document has been recorded and arrived at by Glacier Financial Solutions (Pty) Ltd in good faith and from sources believed to be dependable, but no representation or warranty, expressed or implied, is made as to its accuracy, completeness, or correctness. The information is provided for information purposes only and to assist the financial intermediary to submit an investment proposal to the client and should not be construed as the rendering of investment advice to clients.

Two years ago, our local policy rate started increasing from the lowest level we have ever seen, subsequently increasing at a record pace. In addition, global central banks also engaged in an exceptionally fast pace of policy rate increases from the extraordinarily low levels which we had been in for the better part of the last two decades, thus releasing us from the zero (and indeed even negative) interest rate world which financial markets had grown so accustomed to. All this, of course, with broader ramifications spilling over into other asset classes as well as the real economy, and that's before we even start to unpack the very material ongoing changes to the geopolitical environment, the impacts of climate change, continuation and escalation of major conflicts as well as significant changes to the broader macroeconomic landscape around the globe.

It is therefore very understandable why anyone would draw the conclusion that the last year or two have been one of the 'wilder' periods in the global financial markets. We witnessed inflation spiralling out of control for the first time in decades, central banks rapidly and relentlessly raising interest rates at a record pace, and asset class returns flip flopping from one extreme to the other. Frame this in the context of a global pandemic, the more mainstream acceptance of artificial intelligence technologies, and the heightened concerns about economic prospects, employment, and financial conditions – and it would appear we have been allotted an unreasonably demanding set of circumstances to deal with. However, if you were managing funds in the late 1970s, 1980s or even, to some extent the early 2000s, your experience may have been quite similar in more ways than may seem overtly apparent.

The rate of change in inflation and interest rates is undoubtedly one of the main contributors to this feeling of a new investment paradigm. After all, post the 2007-2008 Global Financial Crisis (GFC), we entered an unnatural period of 'lower-for-longer' interest rates, with near-zero returns on the table for the better part of the last decade. Things became so extreme that almost US$18 trillion debt was trading in negative-yielding territory at the peak, an astounding number and a regime shift that investors had to navigate with little prior notice. At the time, fund managers had adopted a specific acronym for their asset allocation strategies - TINA: There Is (was) No Alternative. The market moves and shifts we have witnessed more recently have changed this equation around quite a bit. Today we see quite several attractive and alternative investment options, for example can be highlighted by the rare case of yield convergences currently seen across asset classes:

.

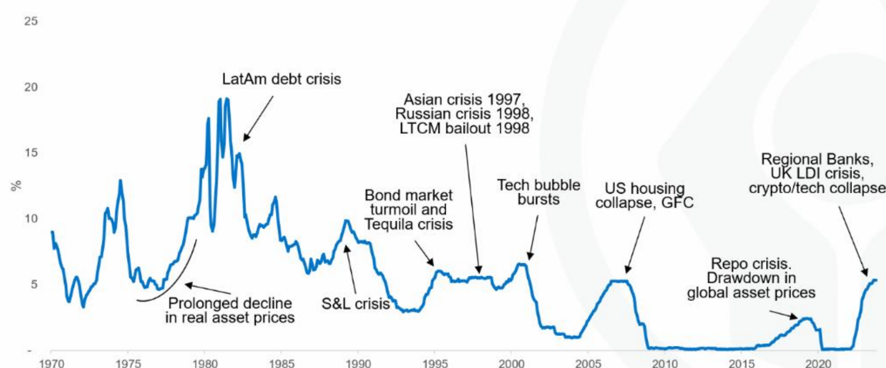
The interest rate (or discount rate) you apply to investment decision making is, in many ways, one of the most essential variables to consider. With global cash rates and bond yields now at much more attractive levels, this reinforces the ability and willingness for asset allocators to divert capital away from more risky asset classes, or at the very least have more viable alternatives to consider. As such, the global interest rate movements significantly impact all global asset allocation return prospects and investment decision making by extension. Returning to our earlier observation about investors' experience and the new investment paradigm, quite a large number of professional investors, analysts, and other participants working in financial markets today would have no experience working in a non-zero interest rate environment, which essentially kicked off in 2008 in the aftermath of the global financial crisis. Today's market conditions represent one of the more seismic shifts in the global economy and financial markets this century. This shift is particularly noteworthy for investment decision makers and financial market participants who generally have had limited exposure to an environment of non-zero rates. It might look like a new investment paradigm because the weight of the current collective human market knowledge interprets it as so. Financial markets have been at these types of junctures before, in fact, for the most significant part of financial market history.

From a portfolio construction perspective, we find ourselves at a very interesting juncture. Fixed income markets are offering some of the best yields and potential return prospects since the turn of the century. This change also comes with very welcome timing. The foreign allowance for South African savers has now increased to 45% due to further legislation changes early last year. This change has a very material impact on portfolio construction considerations, and it once again focused the attention of local investors on the age old questions around foreign allocations – not only how much foreign exposure to include, but also the composition thereof and how to most efficiently and effectively go about this inclusion. The consideration turns to which types of securities or asset classes to add and which will offer the best forms of diversification benefits when included alongside the portfolio of local assets. Remembering that our local markets already have a fundamental composition not entirely dissimilar to the international landscape, with key drivers of return which have varying degrees of correlation to those of international markets. The question is equally relevant for fixed income investors, equity investors, and multi-asset mandates – the local financial market environment is not as deep as internationally, with our local market a mere drop in the ocean by comparison.

The endeavour to include and optimise international assets into a locally based portfolio can (and should) be approached from a number of angles; it is most certainly not a one dimensional consideration. But it is important to acknowledge up front that the potential benefits of including offshore assets stretch well beyond just the traditional quantitative considerations. Diversification benefits should be welcomed outside merely the ability to have more counters and sources of return while taking advantage of cross-correlation benefits. However, that in and of itself is already a very appealing factor not to be taken for granted. In addition, the perhaps more qualitative consideration of 'not having all your eggs in one basket' can be enjoyed even if things turn out for the best, both locally as well as offshore. This rings true now more than ever as we have witnessed international valuations re-rate to much more attractive levels, particularly in the fixed income environment as we have seen interest rates finally lift off their multi-decade lows.

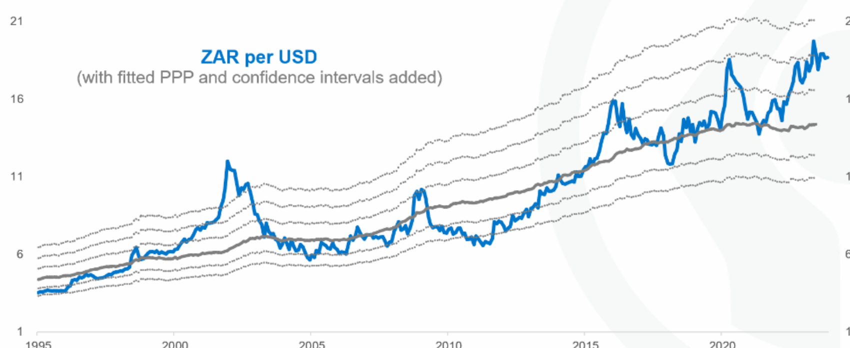
Things have not been plain sailing as fixed income markets have been exhibiting extreme levels of volatility more recently. This has been due to a combination of some real crises coming to the fore and the ongoing grappling with the new realities as analysts wrestle with the incredible pace of central bank interventions, especially in developed markets. The idiosyncratic volatility experienced in the fixed income markets so far this year continue to cause reverberations, even though the credit events in Europe (e.g. Credit Suisse) and North America (US bank failures) from earlier this year somehow seem to feel like they are something in the distant past. The stresses come through quite clearly when taking note of the continued divergences of the volatility priced into the fixed income markets as compared to equity markets. For example, when taking a look at the MOVE index of implied volatility in the bond market, which has continued to trend upward and seems sticky at elevated levels, even as the VIX index has remained significantly suppressed by historical standards:

As the year draws to a close, the US federal funds rate is at the highest level so far this century. With a flurry of debate raging over the future path of policy decisions, it is fair to say there is continued uncertainty regarding the future path of policy rate increases. The 'Table Mountain' path of policy rates from this point onwards is quite an apt analogy – we might be at these higher levels for longer, and it might look relatively flat from afar, but it is much bumpier up close at the top, and we might be in for quite our fair share of volatility for the foreseeable future.

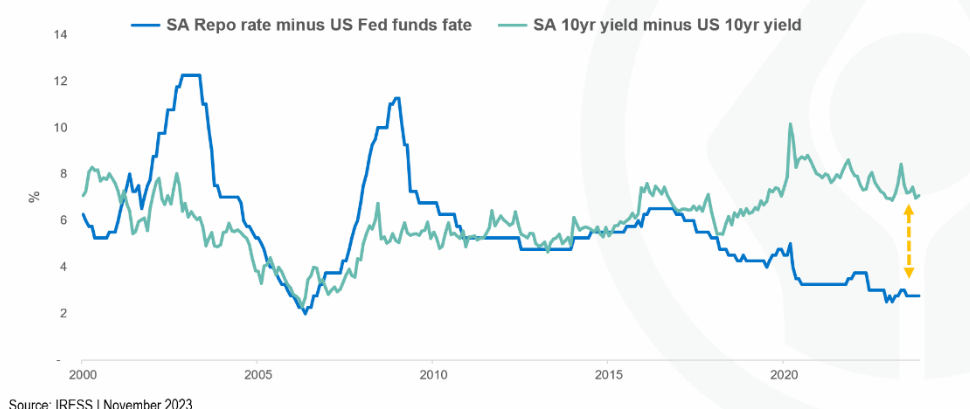


We have, of course, also witnessed longer-dated bond yields trace notably higher and they are in fact at their highest level since the Global Financial Crisis (GFC) – on the back of some very identifiable and quantifiable shifting market dynamics. Of course, with valid concern and debate on the table regarding the impact of higher interest rates on a more highly leveraged economy. From an investor's perspective, the higher level of bond yields brings a welcome alternative from an asset allocation perspective and the ability to allocate capital away from more risky assets into a higher yielding 'low risk' asset if the prevailing circumstances or valuations warrant such a move. The opportunity cost and yield drag on a portfolio is not as great a deterrent as it has been for most of the last decade. It is a very welcome implication that the genuine, real return from cash and fixed interest instruments now offers more of a tailwind when constructing fixed income portfolios as well. It does, however, introduce a layer of complexity to capital allocation decisions. Not least of which is the question around what the relative weighting should be, which is assigned to the outlook for the so-called fundamentals of this investment decision as compared to changes in the macro environment, and in particular interest rates. All of this needs to be considered in the face of the still ensuing debate regarding the potential for softer economic conditions ahead or even the looming threat of recessions in many economies around the globe.

The macroeconomic environment is a material consideration regarding the eventual outcome of these investment decisions, albeit difficult to predict. The very recent past serves as a valuable example of the impact which inflation can have on asset class returns across the board. On the other hand it is clear that growth is a significant driver of longer-term investment returns. With the base case expectation that the lacklustre growth in the local economy is set to continue for the foreseeable future, looking offshore for better growth and associated better potential investment returns is a fair starting point. Indeed, it is most likely one of the more rational decisions which local investors can make with their capital at this point. Important to also keep in mind is that despite the local currency weakness, which South Africans are all too aware of, we have still enjoyed very decent returns from local asset classes over the medium- and longer-term periods even after adjusting for the relative currency depreciation during the past few decades. In addition, the local currency is fragile at this point, so investors should be wary of taking capital offshore with poor timing or even at one of the worst possible junctures.



Thus, we are certainly not suggesting abandoning ship wholesale in search of greener pastures elsewhere, but rather seeing an excellent overall portfolio outcome as a possibility. There are attractive valuations available on local assets while at the same time the benefits of international diversification can be enjoyed. Relative valuations have certainly moved in favour of such a strategy. This is also not to be approached as a macro or 'wholesale' approach, and perhaps a bit of a dangerous generalisation. Even within asset classes, the valuations and prospects of various securities need to be carefully considered. Take the fixed income allocations, for example, where we see local government bond yields as well as our policy rate each trade at their highest levels essentially so far this century, however the relative attractiveness of offshore bonds versus cash not so straightforward. The inversion of the US yield curve compared to the continued steepness of our local yield curve suggests that relative value is to be found on the shorter end of the dollar curves given that one is not being rewarded as much for term or duration risk. In contrast, medium-dated bonds in our local market have the potential for better relative returns to be generated going forward:



Source: IRESS | November 2023

It shouldn't be taken for granted that local and international valuations are at such attractive levels. It is a welcome tailwind to performance, as we have seen inflation rates coming down sharply from their recent highs, but this also implies that the door could open for policy rates to start decreasing going forward. In addition, longer dated bond yields on the local front are trading at exceptionally high levels. As the yields on our local bonds have continued to trend higher, the marginal impact of the associated volatility of these bonds is offset further by the higher yield carry on these instruments. Taking advantage of the current higher yields on the table while they are still available is a good course of action despite the ongoing (indeed ever present) uncertainty from all fronts – be they macroeconomic, geopolitical, financial market related or even other factors which may have a material impact on investment outcomes. The key is to keep a close eye and have one's finger on the pulse to adapt or respond appropriately to changing circumstances and shifting relative valuations.

At the end of the day, the fundamental foundational tenets of fund management and investing remain unaltered, as do the fundamental drivers of investment returns and associated portfolio construction considerations. The investment landscape is constantly changing, and it requires capital allocations to adjust accordingly. Uncertainty is an intrinsic characteristic of the world we live in, but the sense is that the world today seems to be changing at a faster pace than ever, which contributes to uncertainty perceived to be higher. But we are, in fact, in a much more advantageous position than we have been

in a long time – not only are valuations looking much more attractive, but we also have larger sets of information to work with, in addition to better analytical abilities and computing power to assess the environment. This builds the foundations for a much better starting point and will enable us to navigate the ever-changing investment landscape more successfully.

Glacier Research would like to thank Melville du Plessis for contributing to this week's *Funds on Friday*.

Melville du Plessis

Portfolio Manager

Sanlam Investments

Melville joined Sanlam Investments in 2011, taking on a portfolio manager role in the fixed interest team within the active management business. With 18 years' of experience in the investment management industry, his diverse responsibilities have encompassed portfolio management, research, trading, valuations, investment process management and development, as well as product development and execution. Currently, he oversees institutional and retail portfolios totalling approximately R50 billion.

Melville holds a BComm (Institutional Investments) and BCommHons (Financial Risk Management) from Stellenbosch University. He started his career at a boutique investment firm, gaining valuable experience in the hedge fund industry and multi-asset environment. Additionally, Melville earned an MSc in Finance (with Merit) from the University of London and holds the designations of CFA Charterholder, CAIA Charterholder, and Certified FRM.