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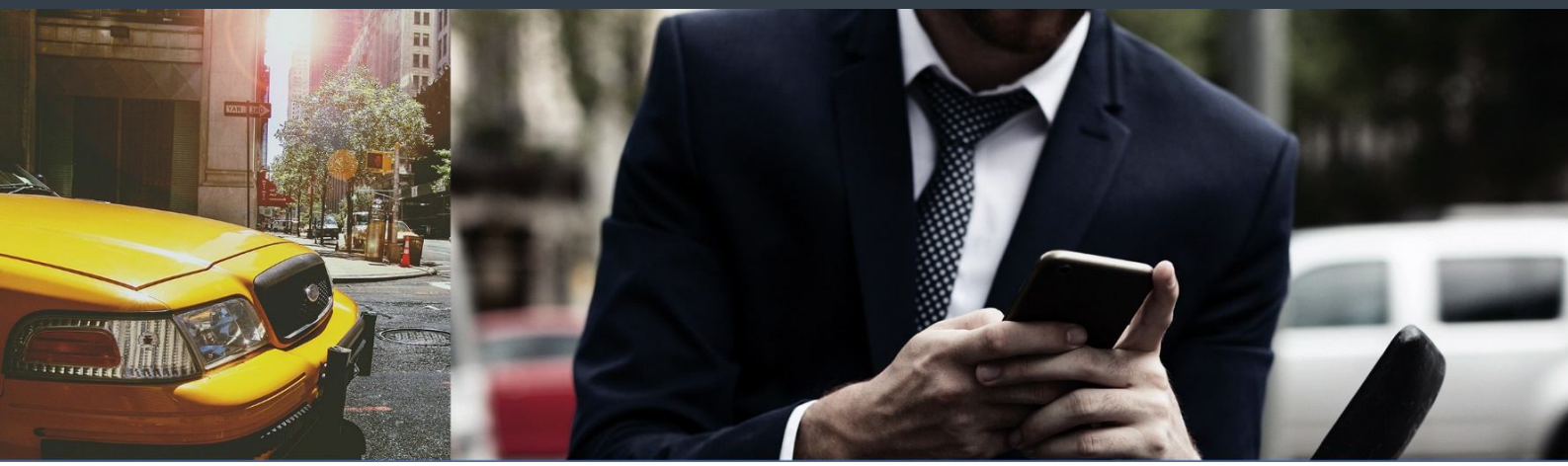

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Life after cash

Written by: Natasha Narsingh, Head of Absolute Returns at Sanlam Investments

For most South Africans, the success of their financial plan depends on striking a delicate balance between risk and return. In many cases, the precipitous decline in cash yields has disrupted that equilibrium. Gone are the days of comfortable inflation-beating returns for very little risk. Investors now face two choices:

1. Maintain their current allocation to cash and wait/hope for yields to rise.
2. Reduce their cash holdings and move up the risk spectrum in search of higher yielding assets.

There are problems with option number one. First, the market currently expects the South African Reserve Bank (SARB) to increase the repo rate from 3.5% to 5.5% over the next 24 months. That'll take the yield on a three-month cash deposit to about 6%. Assuming inflation averages 4.5% over the next two years (could be higher, given what inflation is doing elsewhere) investors who sit in cash will, at best, maintain their purchasing power.

Second, SA's unresolved structural growth issues limit how far the SARB can increase interest rates; if they push the repo rate too high, growth will stall as interest payments on outstanding corporate debt will rise, crowding out investment.

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And third, a staggering amount of debt has been loaded onto government balance sheets around the globe in the fight against COVID-19. This makes it increasingly difficult – some say impossible – for central banks to raise interest rates in any meaningful way without upsetting the global economy. If interest rates remain depressed elsewhere, the SARB won't find it necessary to raise our interest rates to protect the rand and/or attract foreign capital.

Altogether, it seems very unlikely that domestic cash yields will return to their punchy pre-pandemic levels anytime soon. Exploring option number two is the next logical step.

A switch to bonds?

Fixed income, including a switch to bonds, is the next rung on the risk ladder for those going in search of more yield. Invest in the 10-year South African government bond today and you'll be paid a real yield of around 4.5%. There's also the potential for capital gains should bond prices rise and yields fall. Sounds like a potential solution, but what are the risks?

- Our domestic bond market is well correlated to its US counterpart, which is currently under pressure due to rising inflation expectations.
- Softer commodity prices, continued pandemic lockdowns, and failed public sector wage negotiations could all undo SA's fiscal consolidation efforts, key to the performance of our bonds.
- Social and political unrest continue to worsen, dampening foreign investor demand for our bonds.
- As US rates begin to rise in 2022/23, emerging market currencies and bonds may come under pressure as foreign capital is withdrawn in favour of the dollar and US Treasuries.

Countering these risks is the large margin of safety currently baked into our bond yields and the omnipresent demand from yield-starved developed market investors. In addition, less extreme US fiscal stimulus (President Biden's $2trn-3trn infrastructure bill looks set to be trimmed) and a recent flattening of the US yield curve are both supportive of the all-important transitory US inflation thesis.

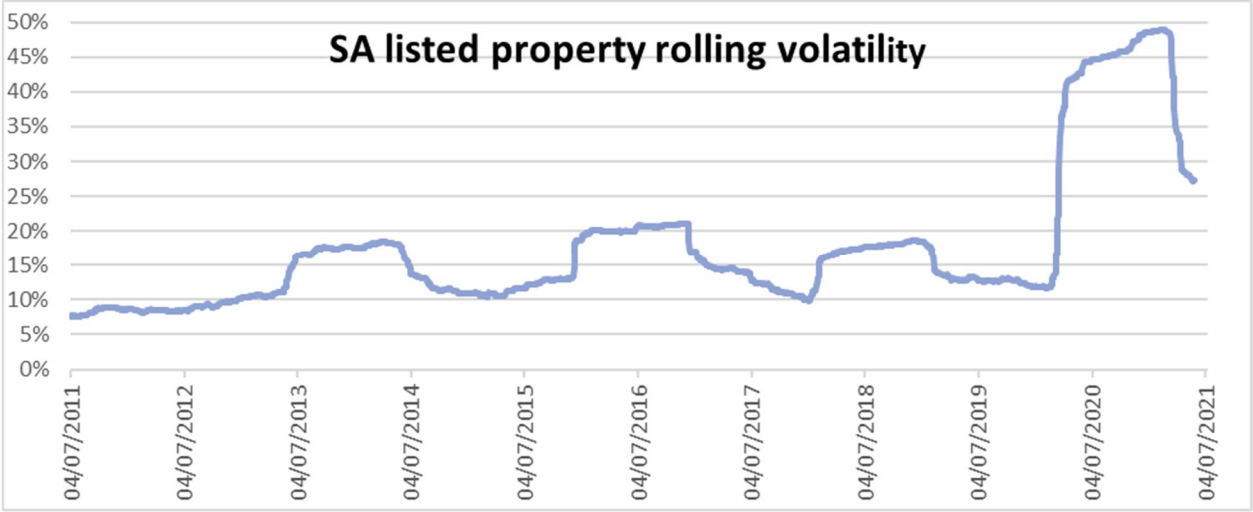
With the above said, bonds are more sensitive to inflation and interest rate developments than cash. The resultant volatility may be unsuitable for those investors who are accustomed to cash-like stable returns.

What about property?

Property is generally considered to sit between bonds and equity on the risk continuum. The pandemic has stretched that assumption to its limit, with the SA Property Index down 28% since the beginning of 2020 while the FTSE/JSE All Share Index has leaked 4% over the same period (at the time of writing).

Does that underperformance, and the valuation it begets, make listed SA property a viable alternative to cash? Given the debt on the incumbents' balance sheets and the uncertainty around future office space demand and economic growth, trading cash for SA property may be a step too far for most investors, especially given the levels of current volatility you can see below.

Graph 1: SA property volatility levels



Source: SIM, 30 June 2021

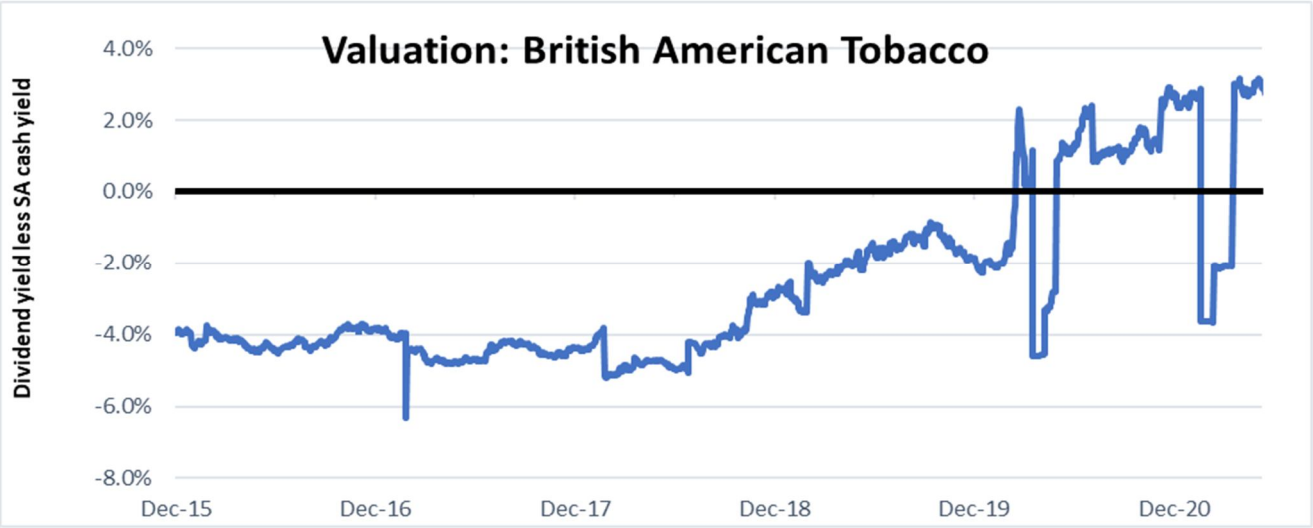
Offshore property might deserve a closer look. One of the striking differences between domestic and offshore property is that the latter universe has more niche sectors. This allows investors to take a more thematic approach to property investing, enabling them to skirt the sectors with weak fundamentals. Besides the likes of specialised plays like Stor-Age, the listed SA property counters tend to be too diversified to fully escape the gravity of our weak economic growth; their portfolios are likely to have some exposure to office, commercial, hospitality, or industrial properties that are under pressure.

Anything in local equities?

It might seem a stretch to move from cash into equities. But while it'll undoubtably raise portfolio risk and volatility, there are select counters that have dividend yields above that of cash with a reasonable margin of safety in their valuation.

They could, therefore, perform an income generation role without introducing excessive capital risk. We believe some of the counters on our local bourse fit this bill. Companies that are highly cash generative – British American Tobacco, for example – should allow for higher capital returns over the next few years. But patience will be required if uncertainty around the spread of COVID-19 remains a feature.

Graph 2: British American Tobacco's dividend yield less SA cash yield



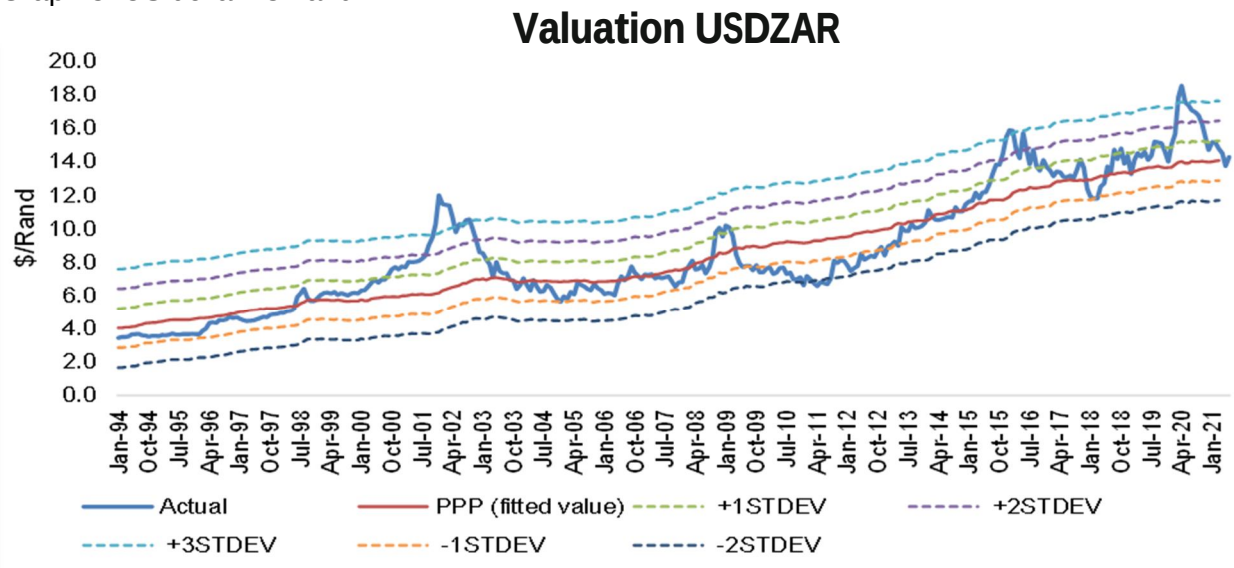
Source: Bloomberg, 30 June 2021

Of course, there are several prevailing risks to the domestic economic growth outlook that could render this asset class wholly inappropriate for investors who are looking for an alternative to cash, so skill and prudence are required when picking stocks for this purpose.

Ship cash offshore?

Shipping money offshore into offshore cash or government bonds would normally be an option but perhaps not currently, as their yields are scant. And you probably won't find the dividend yields to match those available on the JSE. But the case can be made for a weaker rand going forward – which would compensate for lower yields offshore – after a reasonable period of strength that saw our currency reach fair value against the US dollar on a purchasing power parity (PPP) basis, visible in the chart below. And if US inflation is indeed transitory and global economic growth remains resilient, offshore equities should find support as earnings tick over in a low discount rate environment.

Graph 3: US dollar vs. rand



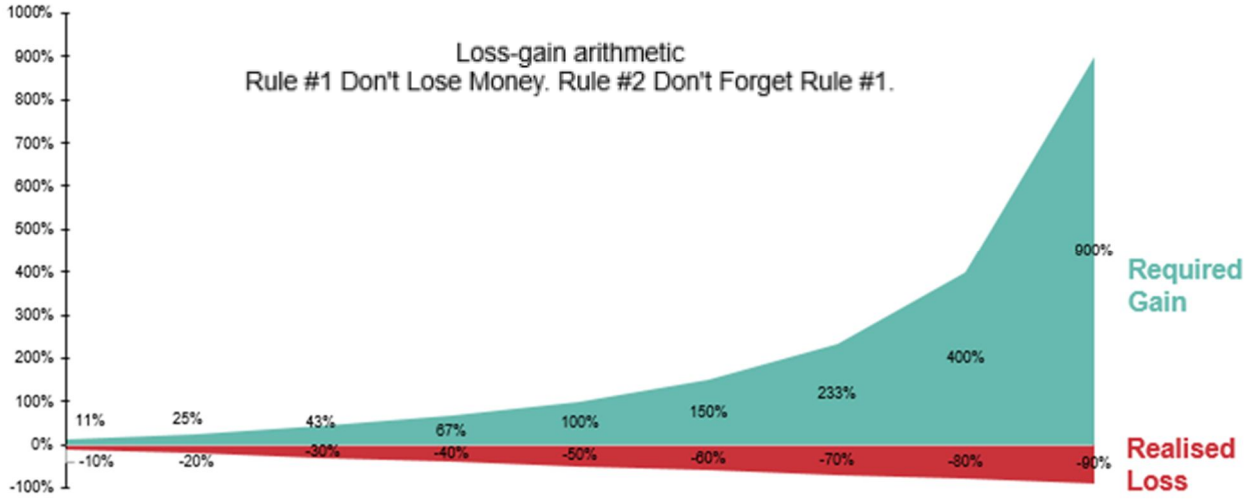
Source: IRess, Sanlam Investments, 30 June 2021

Multi-asset, low equity, absolute return fund?

The risk with any of the above asset classes is that they are positioned for a particular market outcome. If inflation gets out of control, bonds will get hurt; if economic growth stalls, property won't do well; if the Fed turns hawkish too fast, equities will take pain.

For investors accustomed to the smooth ride in cash, that type of volatility is at best not suitable, and at worst dangerous to the attainment of their financial goals. As the chart below illustrates, material losses from adverse market outcomes can be very difficult to recover from.

Graph 4: Required gain to recover from capital losses



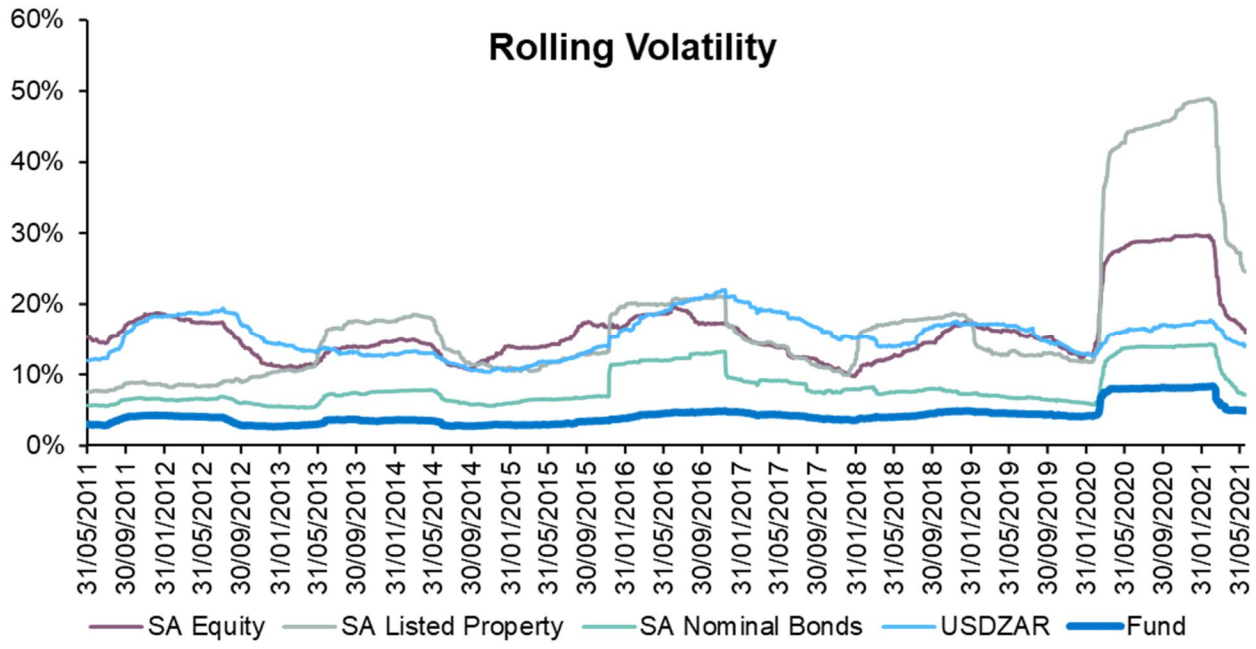
Source: Sanlam Investments

The ideal solution for investors sitting on low-yielding cash, is access to higher yields without the associated drawdown risk.

We believe that a diversified portfolio of income-focused assets, purposefully designed to deliver an absolute and inflation-beating return stream, is a tidy solution for South African investors currently frustrated by low-yielding cash.

Multi-asset low equity funds, by virtue of their ability to access multiple income streams, help investors to achieve a sustainable and robust yield that will perform in different market conditions. However, the introduction of equities into a portfolio also increases the volatility and the risk of adverse drawdowns. Critically then, the yield pick-up in such a strategy should come packaged with downside protection. The latter concept is best illustrated by examining a fund's ability to limit drawdowns in periods of volatility. We present that proof for the Sanlam Investment Management (SIM) Inflation Plus Fund below. It has an explicit capital protection focus, combined with an inflation-beating return target; a fund where investors enjoy the best of both worlds - capital stability along with capital growth.

Graph 5: Volatility of SIM Inflation Fund vs. main asset classes and currency fluctuation



Source: SIM, 31 May 2021

In conclusion, cash is not what it used to be. And it looks set to play a humbler role in portfolio construction for the foreseeable future. To negate the wealth eroding effects of inflation, investors must look to other, riskier asset classes for real yield. But that move needn't introduce unsuitable risk or anxiety. Authentic absolute return strategies are putting their hand up to fulfil that role.

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

Natasha Narsingh
Head of Absolute Returr
Sanlam Investments

Natasha was appointed to head up Absolute Returns after being a senior portfolio manager at Sanlam Investments, manager of the SIM Managed Solution funds and co-manager of the SIM Absolute Return funds, including the flagship SIM Absolute Return retail offering, the Inflation Plus Fund, over a period of eight years. She has a wealth of experience in asset management, along with a breadth of experience across multi-asset classes, including derivatives. Natasha has been with Sanlam Investments since July 2007. She is an experienced portfolio manager who manages several third-party funds in both the institutional and retail fund space.