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# Experience in delivering a 'best investment view' at all times

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## Introduction

With decades' worth of collective experience in the fixed income market, we reflect on the journey to build a "pay it forward" business model in a bid to provide meaningful and sustainable returns in the ever-popular multi-asset income category.

Following below is not only a journey that spans 25 years in the South African (SA) fixed income (FI) market, but also in educating clients that to understand FI, you need to understand yield, and how SA and emerging markets (EM) are joined at the hip.

A consistent lesson to be drawn from the article is how the combination of active management and best investment views contribute towards long-term incremental outperformance.

*Please note this article is an adaptation of the presentation delivered at the Glacier Life Investments Summit webinar, hosted 30 March 2022. Glacier Life Investments Summit 2022 - Zoom (2:00 mark – duration 28 minutes)



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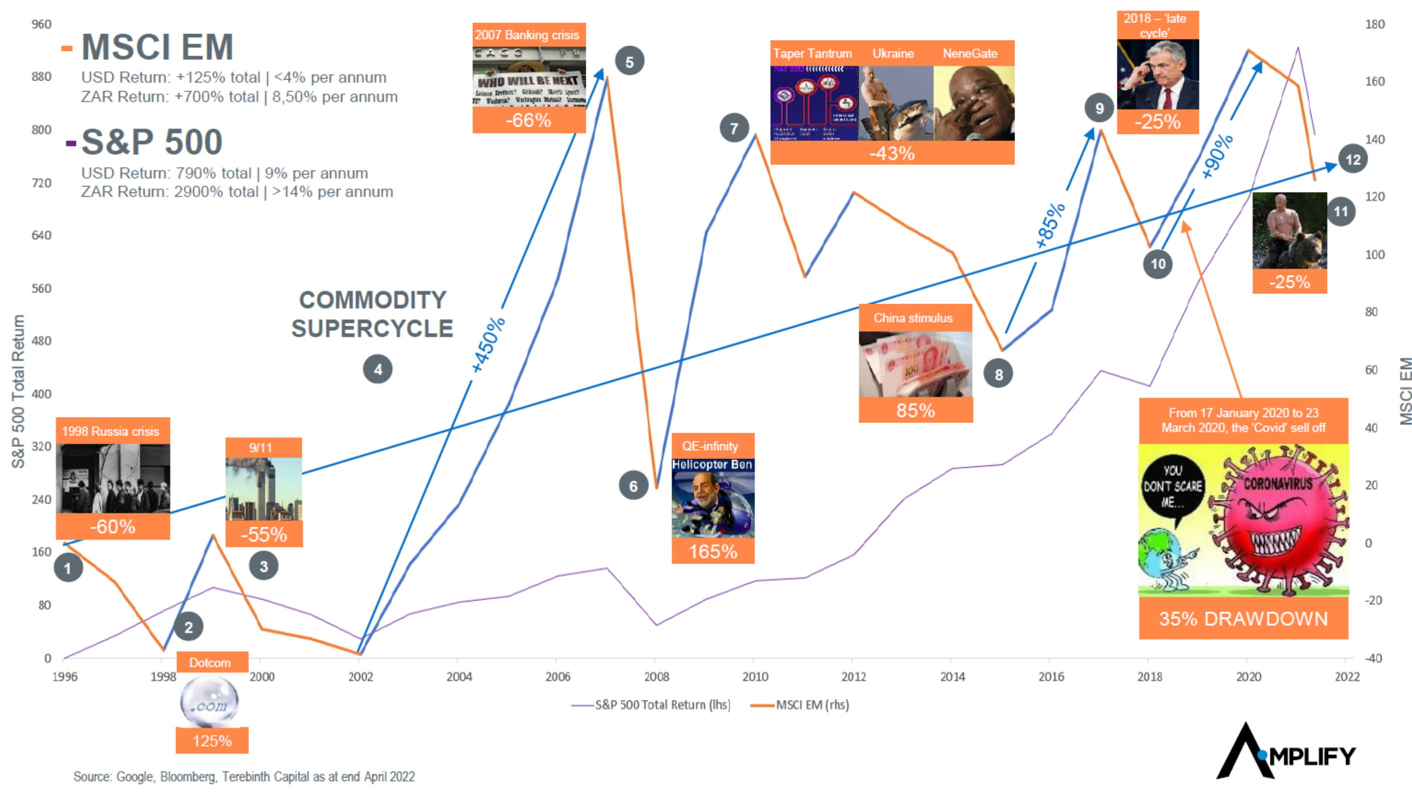
**Figure 1: A 25-year history in a single chart - markets enjoy periods of exuberant optimism and extreme pessimism**




Source: Google, Bloomberg, Terebinth Capital as at end April 2022

## A 25-year journey through market ups and downs

Capturing the journey in a single chart, we illustrate the long-term performance of developed equity markets (DM), depicted by the S&P 500 Total Return Index versus that of EM, measured by the MSCI Emerging Market Total Return Index (Figure 1).

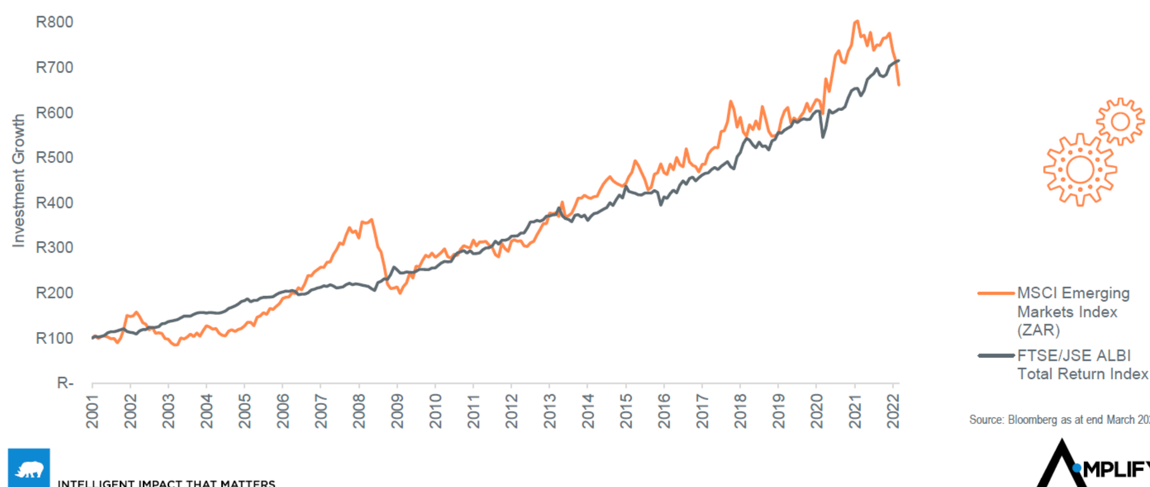
Cumulatively, as would be expected, S&P 500 markedly outperformed EM over the measured period. Yet, the correlation between the outperformance and the introduction of quantitative easing (QE) is undeniable. Collectively, QE1, 2, and 3 added $3.6 trillion stimulus between 2008 and 2012. This outperformance phenomenon will once again repeat in 2020, with QE4, launched in 2020, more than double ($9T) that of the previous 'QEs'.

From a strategic income perspective, the major market events over the past 25 years were the following:

1. The Asian and Russian crises of 1997/1998 caused a 60% sell-off, an early introduction to the idiosyncratic impact of EM events.
2. This sell-off was soon followed by absolute greed, as the dotcom bubble almost single-handedly led to a 125% rally between 1998 and 2000. 21 years later, history repeats with the Reddit/Robinhood rally.
3. The 2000 dotcom bubble bursting, followed by the tragic events of 9/11 which saw markets more than halve from the dotcom heady heights.

4. As China joins the WTO, the longest and most impressive period for EM equities commenced in the early 2000s, marking the start of the commodity price super cycle.
5. Unfortunately, easy money, aggressive lending practices, complex debt instruments, acquiescent rating agencies, and greedy retail investors led to irresponsible borrowing and ballooning debt. This culminated in the 2008 Global Financial Crisis (GFC), with Lehman Brothers the headline corpse in the corporate massacre. In total, EM equities sold off by 66%.
6. The debt super cycle commenced in full force at the end of 2008, as QE1, QE2, and QE3 collectively added $3.6T in stimulus, leading to a 165% recovery. While this move seemed impressive, and the amount of stimulation staggering, it merely allowed the market to recover back to the 2008 highs.
7. As China's industrialisation miracle started running out of steam, in part due to excessive debt, over-easy policies, and the artificial anchoring of low DM rates, the EM underperformance starts from 2013. Over this period, EM was hit by the taper tantrum in 2013; Putin's brutal attack on the Ukraine in 2014; and South Africa's then President Zuma triggering Nenegate in 2015. These factors cost the EM index 38%.
8. The 85% rally during 2016 is often claimed by Donald Trump, but it was China's authorities that came to the market's rescue. Renewed fiscal and monetary stimulus by China's officials countered the negative impact of Brexit and the arrival of a disruptive Trump.
9. In 2018, the market moved into late-cycle territory, with rising credit risk, overconfidence in the Fed's ability to hike rates aggressively, and even higher debt levels. The ensuing 25% sell-off became the precursor to the most bizarre year of this 25-year journey.
10. The COVID-19 pandemic hit the world in 2020 and in one month, the market collapsed by 35%. Despite the existing debt problem, the globally coordinated fiscal and monetary response to the health crisis triggered the biggest rally in many assets within 12 months. Even the EM index doubled over this period. These headline moves were dwarfed by exponential rises in obscure companies such as Blockbusters (a bankrupt video rental company), as the US government took Bernanke's helicopter drop to the next level. Global debt exploded from already scary levels, raising the ire of inflationist as QE4 totals $9T.
11. A mid-cycle slowdown, fears of tighter monetary conditions, and a more brutal attack by Putin on Ukraine led to a 25% drawdown in EM from the 2021 peaks.
12. Over this 25-year period, EM equities generated 700% returns (in rand terms) at an annualised average rate of 8.50%.

**Figure 2: South Africa is a poster-child EM proxy**




## Bringing it home

It may be perplexing to start off a strategic income discussion with global equities, but there is method in the madness.

EM FI is seen as a risky asset class and as such, tends to have a high correlation to global equities. With SA being a typical EM in most respects, we would expect SA FI to exhibit similar characteristics.

SA is a small, open economy, a price-taker on the global stage, long on natural resources, with lower-skilled labour, a young population and room to improve on the leadership front. Perhaps its debt levels are higher than other EMs, but its sophisticated financial markets and size of the local savings industry enable higher debt levels.

In many respects, SA is the opposite of the average DM, which is why one can expect high yields. High yields generally mean a greater potential for high returns. This is what we have experienced in SA: The FTSE/JSE ALBI total return has matched the MSCI Emerging Market Index in rand terms almost tick for tick (Figure 2).

## Lower volatility, same outcome

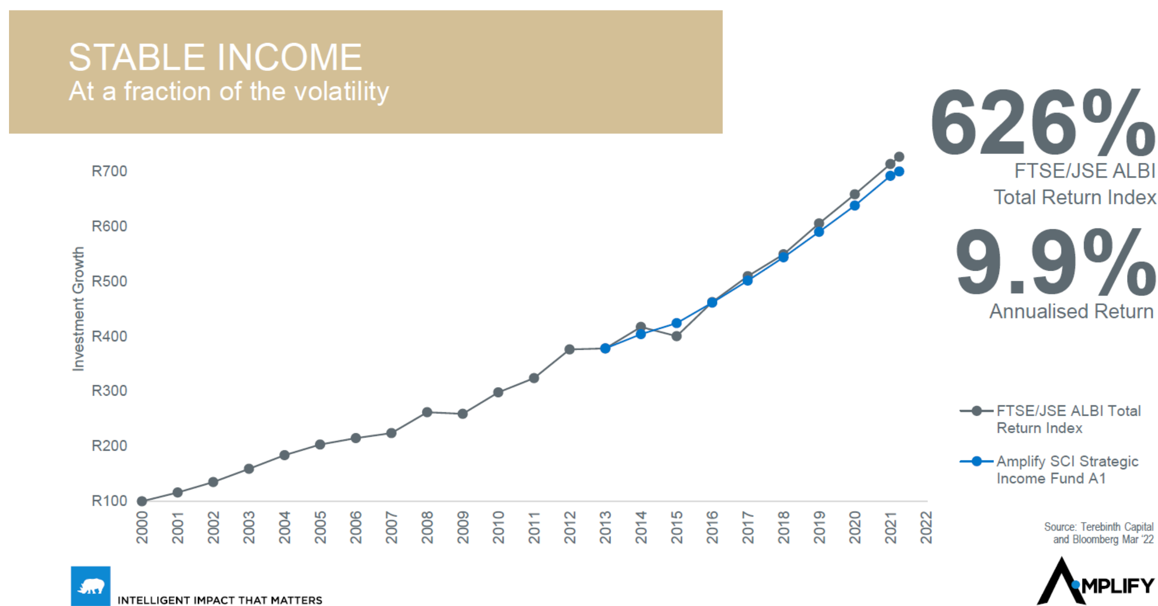
Strategic income funds have their origin in the early 2000s. The original intention of this solution was to achieve the ultimate goal – superior returns with limited volatility – by outsourcing the entire asset allocation decision to the manager across the full income asset class spectrum.

As a Regulation 28-compliant solution, the mandate allows for offshore allocation, however full utilisation of the allowance is unlikely to minimise volatility. Similarly, the mandate is allowed to hold up to 25% in listed property, but a more appropriate limit for this volatile asset class is likely somewhat lower.

The distinguishing factor in ensuring sustainable long-term success with these strategies lies in allowing the manager to be highly active and agile in allocating across allowed asset classes. A strict investment framework, that allocates to deep and liquid markets, makes it easier to implement effective diversification, while delivering on the best investment view.

The outcome should result in an income solution with returns that compete successfully with the South African government bond (SAGB) market, but at a fraction of the volatility.

**Figure 3: It is not just about 'duration', it's about being active in a macro way**




## The secret sauce

To achieve lower volatility, regardless of market conditions, the fund manager must have experience in the relationships between various instruments, at their disposal as well as their behaviour across different market cycles. Examples are forex, swaps, preference shares, floating rate notes (FRNs), negotiable certificates of deposit (NCDs), sovereign bonds, inflation-linked bonds (ILBs), offshore investments, and property.

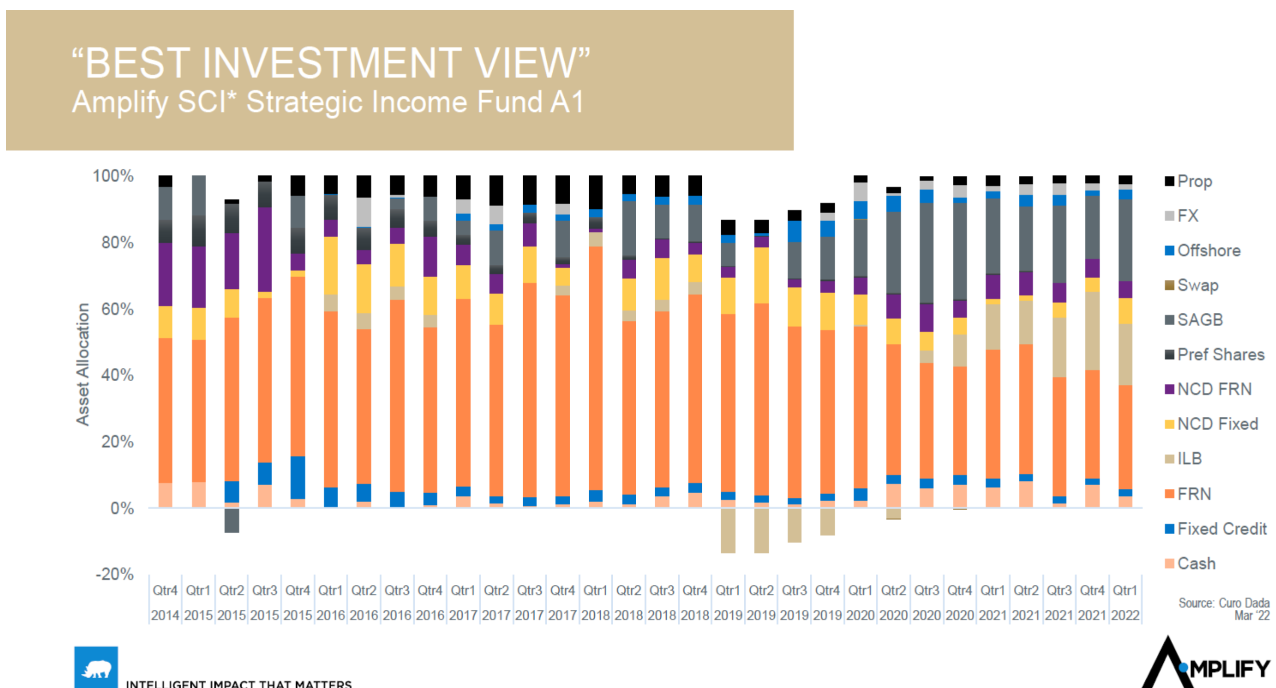
As markets are prone to periods of euphoria and despair, as can be seen from Figure 1, being able to identify and position for mispriced assets across the opportunity set is key. Avoiding career-shortening drawdowns (Figure 4) while remaining active allows some strategic income funds to deliver a level of return beyond their cash-plus benchmarks, but without the stress that comes with positioning for a single market outcome, and with lower volatility than only investing in the FTSE/JSE ALBI.

**Figure 4: Incremental returns are generated by protecting the downside**

This approach also deviates significantly from a credit-heavy asset allocation approach. The reason for highlighting this is that there seems to be a renewed focus on the Sharpe ratios for these mandates. Given the lack of liquidity in, and price discovery of, the SA credit market, illiquidity is often confused with value. Figure 4 clearly highlights how volatile the fixed income asset class can be. It is naïve to think that credit will not be at least as volatile if it offered liquidity and a true reflection of price during periods of market distress.

Figure 5 illustrates the scope and flexibility that SA multi-asset income funds have at their disposal. No asset class should be exempt from being reduced to near zero when following a true best investment view approach. And with enough conviction, those same asset classes may materially exceed industry-average weightings.

**Figure 5: Staying active through cycles**



## Conclusion

If one considers a cyclical approach to investing, it should become clear how an agile and active asset allocation process – that invests in deep and liquid markets where the true value of each holding is always reflected – can proactively adjust to changes in the macro cycle.

Importantly, scenario analysis assists greatly in understanding the implications of deviations from a core best investment view scenario, such as:

- The impact of a Nenegate
- The recall of Gordhan from a foreign roadshow
- Brexit
- Navigating the unexpected, such as COVID-19
- Reflation to mid-cycle resets
- Key geopolitical events

The journey started with a detailed analysis of events in EM over the past 25 years. 'Stuff' will always happen. None of us have the luxury of perfect 20/20 foresight. However, it is our task to allocate capital diligently, following a rigorous process, always reflecting best investment views, while ensuring income and offering liquidity. To be sustainably successful, you need to stand for something (a core view) in an active way, otherwise you will fall for anything.

Experience has shown that it is imprudent to position for a single outcome, as it is irresponsible to believe a core view is the only possible future. It is for this reason that a scenario approach, relying on detailed cycle analysis, allows capital to be allocated diligently, and efficiently, through an active approach. This will contribute to consistent, meaningful returns to those entrusting their hard-earned savings to us.

## Glacier Research would like to thank Erik Nel for his contribution to this week's *Funds on Friday*.

**Erik Nel**

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Erik, co-manager of the Amplify SCI* Strategic Income Fund, established Terebinth Capital in April 2013, after launching the absolute suite of products at Atlantic Asset Management in January 2009, that included the award-winning Atlantic Point Fixed Income Macro Hedge Fund. He was instrumental in assisting with the launch of RMB's Fixed Income research platform. He previously held positions at LASMO Plc in the UK & Coronation Capital. Prior to joining RMB, Erik headed up Institutional Fixed Income Sales at Nedbank Capital.