

ASSET ALLOCATION 2020: MAINTAINING A LONG-TERM PERSPECTIVE

PETER BROOKE
HEAD OF MACROSOLUTIONS



Our long-term return expectations are updated every six months, where we step away from the daily noise and refresh our long-term strategic thinking. This includes updating our expected returns by asset class using a five-year time horizon. We focus on real returns, by way of stripping out inflation. Given that these are long term numbers, the changes are often quite small but the impact on how to allocate is large. Our bi-annual review is more important than ever as the extreme volatility in markets makes it easy to become un-anchored. A record fast crash in Q1 and a massive bull market in Q2 are enough to make anyone's head spin. We have seen unprecedented monetary and fiscal stimulus of an estimated \$US18.5 trillion, which will ensure that the world economy recovers. However, markets have already pre-empted that and we are lowering our return expectations.

LOWER RETURNS ON GROWTH ASSETS

Interestingly, we've only done two interim reviews in the last 12 years in March in 2020, when markets got too cheap; and in March in 2015 when markets got too expensive when we introduced the "low return world" theme. Our work in March this year helped us to buy equities in the crash, but as markets rebounded, the valuations have since deteriorated.

Where we were expecting a real return of 7% from SA equities in March, we've had to cut it to 6%. There are some exceptionally cheap companies in South Africa especially on a price to book basis.

Offshore, we've cut our real global equity return to 4.5% from 5.5%. This lower return is mainly driven by higher valuations in the US, while the rest of the world still offers some reasonable valuations. We are overweight to non-US equities, having bought Asia early in the crisis and, more recently, we have started adding to European equity. Europe has been a typical value trap but the degree of fiscal stimulus leads us to believe earnings will recover sharply in 2021.

We have also trimmed our real return for SA property to 6.5%. This reflects some harsh assumptions from our property specialist, Evan Robins. He assumes that property companies are forced to rebuild their balance sheets through no dividends and having to raise equity. If there isn't a need to raise as much equity, the return will be a bit better. Despite the high return from property, we prefer equity due to the better relative theme. Remember our philosophy uses a two dimensional approach with theme and price and the property sector theme is poor – disruption from e-commerce and Work-from-Home resulting in excess capacity and a loss of pricing power.

A SIGNIFICANT CHANGE IN ALLOCATING CASH

Probably the most important change, is that we've cut our expected return on SA cash to only 0.5%. As we have highlighted in recent commentary, the last five years have been very unusual in the degree of outperformance of cash relative to equity. With the slashing of local rates to levels not seen since the 1970's this will normalise over the next five years. As a result one can no longer leave money in cash and we are actively investing the cash in our portfolios. We have re-introduced a theme from nearly a decade ago "cash is trash".

SA bonds still offer an exceptional real return of 5%, which is very attractive. In a global context of aggressive central bank intervention, the yield on offer stand out like a sore thumb and we expect negative real returns from offshore cash and bonds. The steepness of our yield curve is due to our deteriorating fiscal situation and the government faces a stark choice. Either print money and lose control of the currency, or deliver much needed reform enabling South Africa to enjoy one the greatest bond bull markets in the world. It is hard to tell which path we will take as the government dithers, creating a binary risk.

REDUCED RETURN EXPECTATIONS PUT TARGETS AT RISK

Pulling these changes together, one can calculate the expected real return from a balanced fund using a passive allocation. On this basis, we would expect a real return of 4.6%, nearly a percent lower than the 5.5% we had in March. Back then we were very confident that we would hit our real return target over the next 5 years. However, now, it will be a little tougher. The unfortunate truth is that the monetary and fiscal stimulus that is being applied globally will have to be paid back in the future, which will result in lower returns. Remember that there have been more than 900 rate cuts since the Global Financial Crisis started. Offshore we are not being rewarded for this, unlike in South Africa where assets are cheaper. As a result we are overweight South African bonds to increase our chances of hitting our return targets. In addition, we own a number of local shares that have underperformed sharply in the last 12 months and we expect that these will recover. This will result in alpha or outperformance – better returns than the 6% real return expected from SA equity, enabling us to deliver a balanced fund target of 5% real.

Today, financial markets, medical health and government policy are simultaneously exhibiting extraordinary circumstances and have created an environment of extreme volatility – one where the future is even more unclear than before. In this type of environment, maintaining a long-term perspective and building diversified portfolios is crucial.

THE SYMBOLS

NEUTRAL: Real returns will be at or around the long-term historic average over the next five years; the weight in each of our portfolios is roughly equivalent to that of their benchmark, where applicable.

NEUTRAL +: Real returns will likely be at or around the long-term historic average over the next five years. However, as there may be some opportunities available for us to capture some alpha, the weight in each of our portfolios may be slightly overweight to that of their benchmark, where applicable.

+ (positive): Real returns will be above the long-term historic average over the next five years; our portfolios are overweight compared to their benchmarks, where applicable.

NEUTRAL - : Real returns will likely be at or around the long-term historic average over the next five years. However, due to prevailing negative conditions, it is likely that our portfolios may be slightly underweight compared to their benchmarks, where applicable.

- (negative): Real returns will be below the long-term historic average over the next five years; our portfolios are underweight compared to their benchmarks, where applicable.

EXPECTED LONG-TERM REAL RETURNS (JULY 2020)

	Real return	View	Comment
SA		+	SA assets offer better real returns
Equity	6.0%	+	Earnings risk to downside
Property	6.5%	Neutral	Keep the survivors
Bonds	5.0%	+	Great real return even for “junk”
Cash	0.5%	-	Cash is trash
Global		-	Still maintain some diversification
Equity	4.5%	Neutral +	Preference for non-US
Bonds	-1.5%	-	Rewardless risk
Cash	-1.5%	-	Zero rates