DFM QUARTERLY

OCTOBER 2022

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DFM QUARTERLY

Insights on building your wealth.

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We hope you find relevant insights in the Spring Edition of the INN8 invest DFM Quarterly.

INN8 INVEST

Recession Clouds Gathered Over the Global Economy

> *It's a recession when your neighbour loses his job; it's a depression when you lose yours.* – **Harry Truman** (Former US President)

War on rampant inflation intensifies

The "R" alarm is ringing as the threat of higher borrowing costs hangs over global markets. Interest rates around the world are rising at an alarming pace – around 90 central banks have raised interest rates this year – as central banks admit that inflation is becoming more ingrained, rather than just a series of transient shocks.

US – there are few signs that the labour market or inflation data is slowing sufficiently for the Fed to declare 'victory' on inflation. The Fed raised rates by another 0.75% at its September meeting, meaning that the most important interest rate for the global economy has risen six-fold in the space of just four months.

Europe – the European Central Bank (ECB) also intensified its battle against record inflation by hiking interest rates by a historic 0.75% in September and pledging 'several' further increases, even as the outlook for economic growth darkens. After 6 months of war in Ukraine, natural gas prices hit a record high, adding to an inflation pulse that is sure to drive more painful policy tightening, exacerbating the risk of recession.

UK – the Bank of England increased rates by another 0.5%. UK inflation is now predicted to peak at just under 11% in October with rising inflation being dubbed the 'cost-of-living crisis', as home energy bills are set to triple in as little as two years. To stem runaway inflation, the government announced an emergency energy support package in its battle to bring inflation down to its 2% target.

SA – the repo rate was hiked another 75 basis points in September, bringing the rate to 6.25%. The latest interest rate hike follows a painful inflation number that peaked at a 13-year high of 7.8% in July, before moderating to 7.6% in August. The SARB expects inflation to average 6.5% for this year.

You always have outliers...looser monetary policy

China – in contrast, the world's second largest economy, trimmed its loan prime rates (LPR) last quarter, one week after the central bank unexpectedly trimmed the one-year medium-term lending facility (MLF) rate after data showed the Chinese economy was losing momentum amid slowing global growth. Core inflation remains weak allowing the PBoC to maintain its policy stance to support the slowing economy. More rate cuts are expected by year end.

China announced 19 new policies aimed at beefing up efforts to rescue economic growth, which include more than 1 trillion yuan ($146 billion) in new funding to boost investment and consumption.

Japan – Japan's key inflation gauge rose further above the Bank of Japan's (BoJ) target level of 2% in Q3, a result that will likely maintain speculation over possible policy adjustments at the central bank, despite Governor Haruhiko Kuroda's continued commitment to ultra-low rates. Despite the continued price gains, the BoJ is unlikely to budge from its position as an outlier among global central banks any time soon.

MARKET OVERVIEW

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No surprise...global growth revised down – again

Monetary policy tightening by central banks is therefore expected to weigh on global growth this year and in 2023. The International Monetary Fund (IMF) has forecast global growth of only 3.2% for this year and 2.9% for the next. Since 1980 the world economy has posted an average growth rate of 3.4%.

In South Africa, the Reserve Bank downgraded its expectation for growth this year to 1.9%, from its previous prediction of 2.0%. It downgraded its forecast for growth sharply for the following years to 1.4% in 2023 and 1.7% in 2024, below the 1.9% for both years that was expected in May this year.

Be on the lookout ... the inverted yield curve

One of the key market metrics to follow closely is the US yield curve. Yield curve inversions have a good track record of happening right before a recession in the world's largest economy. At the time of writing, the yield curve remained inverted with the 2-year yield trading higher than the 10-year yield – roughly 45 bps – and is now the most steeply inverted since 2000.

Curve your enthusiasm - US 2s/10s yield curve at deepest inversion in over two decades

Source: Bloomberg

Global financial markets

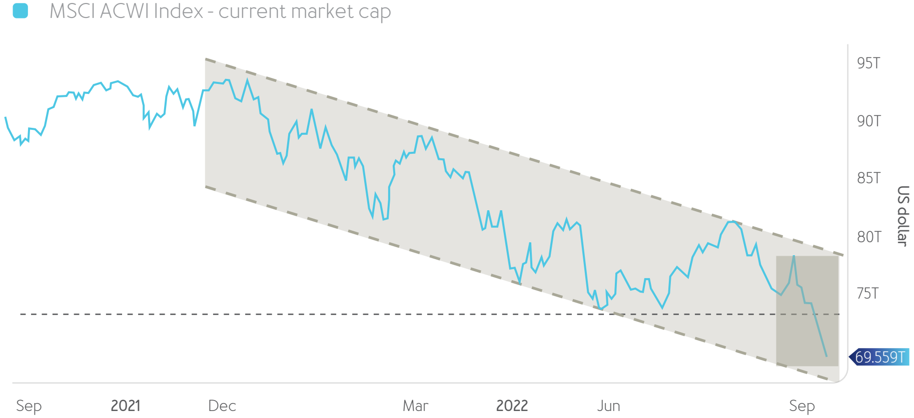
Growth fears roil equity markets

Global stocks have been under pressure during the past quarter. News about sky-high global inflation, the energy crisis in Europe, war in Ukraine and currency volatility all contributed to the growing uncertainty in financial markets. With a global recession looming risk assets have been in a tailspin and global stocks have slumped into a bear market. The broader MSCI World Index dropped another 6% in US dollar terms for the quarter and is now down 25% YTD.

The quarter started well, with a strong rally in July seeming to be an illustration of the old saying that 'the market is not the economy'. Global stocks had one of their best months in two years despite discouraging news about both global growth and high inflation.

But in September markets tumbled again. The MSCI World Index has lost more than $8 trillion in value since a mid-September peak.

Deepening sell-off: MSCI World members lost trillions of dollars in September



Source: Bloomberg

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Overall, 'tech heavy' index stocks in the US contributed mostly to the negative return of the MSCI World Index, with information technology representing roughly 20% of the MSCI World Index. The Nasdaq Composite Index lost 4% in Q3 and is down 32% in US dollar terms over the past year. Profitless tech stocks took a 'pounding', losing more than 60% over the last 12 months. Tech stocks are particularly vulnerable to higher interest rates as they mean a bigger discount for the present value of future profits, hurting growth stocks with the highest valuations, while boosting 'cheaper', so-called value shares.

Bonds in bear market – no place to hide

Bonds – which are usually regarded as a safe haven when equities sell off – are also losing money in this equity bear market.

Rising inflation and interest rates have negatively impacted the price of bonds, sending the Bloomberg Multiverse Bond Index – which provides a broad-based measure of the global fixed-income bond market – down 14.6% in US dollar so far in 2022.

Tighter global monetary policies have pushed bond yields up. 10-year US treasuries have sold off from 1.5% at the start of the year, to almost 4% in September.

Runaway dollar causes havoc in currency markets

The US dollar has had an incredible run throughout 2022, appreciating against most major currencies. But why? Rising rates in the US and global markets pointing towards a major slowdown, and the war in Ukraine, are prompting a 'flight to safety'.

This year alone, at the time of writing, the dollar is up a record high of 17% against the British pound. The weakness of the pound was further aided by the UK government's announcement of sweeping tax cuts funded by steep increases in government borrowing. Investors are concerned about the UK's ability to manage so much extra debt – 14% compared to the euro, a 20-year high and up 25% against the Japanese yen. In an extraordinary move last month, the BoJ intervened in the currency market to support the yen for the first time since 1998, seeking to stem the decline against the dollar.

Although it has been a period where the dollar has been stronger against developed markets (DMs) relative to emerging markets(EMs), we all know that EMs live their economic lives at the mercy of the dollar. It may sound blunt but there are three ways in which a stronger dollar makes life tough for emerging economies.

1. MANY EMS – largely the poorer countries – borrow heavily in dollars and to their detriment, because it becomes more difficult to make repayments as the dollar rises and their currencies depreciate. The amount of cross-border dollar-denominated credit outstanding in EMs has risen fourfold since 2006 to more than $4 trillion.

2. A STRONG DOLLAR can also weigh on trade. The dollar dominates international transactions. Firms operating in non-dollar economies typically use it to quote and settle trades. Consider a key commodity such as oil, which is bought and sold in dollars.

3. Lastly, MOST EMERGING MARKETS ARE PRICE-TAKERS – their policies and actions do not impact global markets – and are largely dependent on global trade. As the dollar strengthens, imports become expensive in domestic currency terms. Although the so-called 'pass-through' from the exchange rate to inflation has tended to be relatively low in recent years, things have changed and could quickly lead to higher inflation for EMs.

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Emerging markets

EM equities were hit the hardest. The MSCI Emerging Markets Index lost 11.6% of its value in US dollar terms in Q3. The CSI 300 Index in China has fallen 15% for the quarter and is down 23% in US dollar terms YTD as investors have had to grapple with stringent Covid curbs, a deepening property crisis and a continued crackdown on internet giants. Chinese stocks make up approximately 31% of the EM Index and adversely impacted the EM Index return.

Locally – equities see red as we battle to keep the lights on

The FTSE/JSE All Share Index fell 1.9% in Q3 to 63 726, bringing its YTD sell-off to 13.5%. Leading the fall this year is industrials (-16.8%), followed by resources (-6.5%) and financials, which shed 3.0% of their value.

Resources suffered from the fall in most commodity prices as investors started worrying about China's zero covid policy and the impact on its economy. The war in Ukraine added to the sector's woes, pulling down economic growth in Europe. In financials, Absa and Nedbank bucked the trend, rallying 15.8% and 14.1% respectively but poor results from Capitec pulled the sector down. In September, Capitec experienced its third largest monthly fall in more than 22 years after its results pointed to the inevitable slowdown in earnings growth and pressure on the quality of its R70 billion unsecured loans book, given its more economically challenged customer base.

Domestic fixed income showed more resilience in Q3

South African nominal bonds started the quarter well, rallying 2.4% in July and adding another 0.3% in August. However, the hawkish tone from central banks dampened the mood in September, with the market losing 2.1%. However, the All Bond Index still managed finished the quarter up 0.6%. YTD bonds are down only 1.3%, outperforming SA equities and property. Cash was once again king for the quarter, returning 1.3% and gaining 3.6% YTD.

SA property had one of its worst quarters

The FTSE/JSE SA Listed Property Index lost 3.5% in Q3 and is down 15.8% YTD, making it the worst performing asset class in the domestic market.

Global fund raising – JSE struggling but China defied all the headwinds

THE GOOD NEWS is that the first cannabis stock, SPAC is to list on the JSE. The bad news is that the trend of delistings – as discussed in the Q4 2021 Market Commentary – persisted into 2022 with a list of local companies expected to leave the JSE.

Massmart's parent company, Walmart, said it will make an offer to buy out the 49% stake it does not already own in the local retailer. The US company plans to then delist. Grindrod Shipping will also delist, should an acquisition bid by Guernsey-based shipping company Taylor Maritime Investments (TMI) succeed. Earlier this year, the PSG Group announced its plan to delist while the acquisition of Mediclinic by a Remgro-led consortium, will result in the JSE exit of the hospital group, once approved by shareholders. The negative trend remains a worry..

IN CONTRAST, the IPO market in China has defied all the headwinds, despite declining global stock markets. As of August, IPOs on Chinese stock exchanges raised nearly $58 billion, which is a record high for such a period, according to Bloomberg data. From January to August this year, IPOs in China raised nearly three times as much as listings in the US, according to market tracking platform Dealogic.

UP UNTIL NOW, Chinese companies have been attracted by the much bigger and less volatile pool of capital in the US, which can potentially be tapped much faster. China's own markets, while huge, remain relatively underdeveloped. Though, since the US-China 'trade war' began in 2018, together with the potential delisting of some 200 Chinese firms from next year onwards, China has purposely tried to reduce its dependence on US financial markets, choosing instead to rather raise funds in the home markets. It should therefore, not come as a surprise to see the IPO market in China bustling with activity.

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More reasons for the big surge in IPOs are:

ECONOMIC CONDITIONS

The surge in listings is partly driven by concern that economic conditions could worsen later in the year as flare ups in virus cases cause Beijing to stick to the strict Covid Zero strategy.

POLITICAL UNDERTONES

Telecom provider China Mobile Ltd. and energy producer CNOOC Ltd., the biggest debuts of 2022, both listed at home after being kicked out of the US following their inclusion on a Donald Trump-era blacklist. In China, they raised $8.6 billion and $5 billion, respectively and are trading well above their listing prices.

PATRIOTISM

Buying stocks that help China to be more independent from rest of the world. A lot of the stocks now coming to market in China are from the tech sector, that investors seem eager to buy given the focus on building up home-grown capabilities.

AUDITS

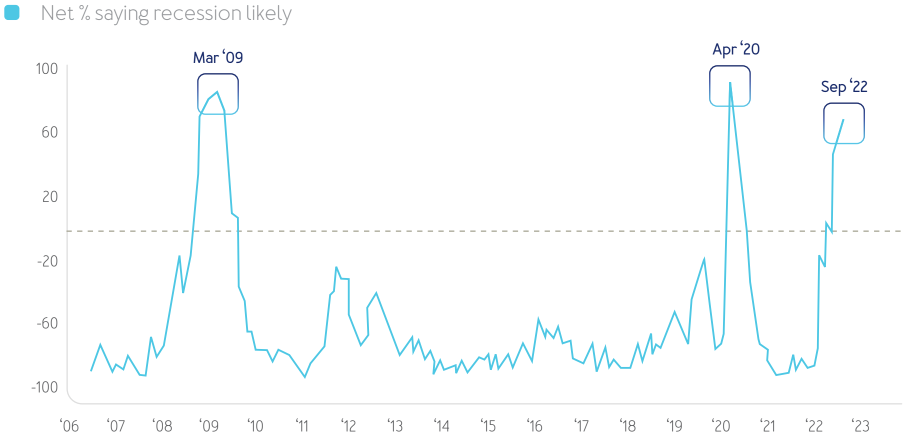
Three state-owned Chinese corporate giants – PetroChina Ltd, China Life Insurance Ltd and China Petroleum & Chemical Co – announced plans this past quarter to remove their shares from the New York Stock Exchange, adding to a growing financial separation between the biggest global economies in the middle of a dispute about scrutiny of company audits.

Conclusion

The global economy is facing a bleak picture – high inflation and aggressive steps by central banks to curb it. The latest BofA Global Fund Manager Survey shows that 58% of participants anticipate a US recession in the coming 12 months.

For the most part, economists are generally describing any potential upcoming recession as mild or moderate – although Economist Nouriel Roubini, nicknamed Mr. Doom, who correctly predicted the 2008 financial crisis, sees a 'long and ugly' recession in the US and globally occurring at the end of 2022 that could last all of 2023.

Recession odds still rising



Source: Bloomberg

All recessions are worrisome and even a mild recession would likely still mean a decline in economic activity spread across the economy, lasting more than a few months – normally visible in production, employment, real income, and other indicators. Stock markets are also likely to struggle during recessions. As consumer confidence and spending decreases, companies may be forced to lay off workers, which can lead to more weakness in risk assets.

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There is no shortage of opinions on whether a downturn is inevitable, when it might start and how bad it might be. One reason this downturn could prove longer lasting is that high inflation may hold the US Fed back from stepping in to support the world's largest economy. It is worth noting as the clouds gather, that it is difficult to forecast when, and if, a recession will occur. If the yield curve in the US remains inverted and results in an economic recession, the lead time between the two events could be up to two years. Since 1956, it has taken between five and 24 months for a US recession to start after a yield curve inversion.

But let us rather be optimistic and hope the largest economy in the world can avoid a hard landing.

Albert Louw CFP®

Practice Manager: INN8 Invest

INN8 INVEST FLEXIBLE INCOME

Performance Snapshot - 30 September 2022

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Performance attribution

Returns (net of fees)	3 m	1 yr	3 yrs	5 yrs
Inn8 Invest Flexible Income	1,3%	4,9%	6,4%	7,3%
ASISA South African MA Income peer average	1,2%	4,4%	5,6%	6,5%
CPI +1% (1 month lag)	*3,1%*	*8,7%*	*6,2%*	*6,0%*

Source: Morningstar. Returns are net of fees.

Performance drivers over the past three months

	What helped?	What detracted?	Comments
Asset allocation	• Underweight SA Equity • Overweight Global Cash	• Underweight SA Cash	• The solution performed largely in line with its benchmark. Aluwani did well from instrument selection, Sasfin and Amplify also performed well as longer duration was rewarded in Q3. Ninety One held up well from its high cash position. Coronation and Granate struggled as ILBs sold off but the same position has added value this year.
Manager selection	• Aluwani Flexible Income	• Granate BCI Multi Income	

How is the Solution positioned?

Equities	Bonds	Property	Cash	Global
Weighting: 0,8%	Weighting: 79,5%	Weighting: 2,2%	Weighting: 17,5%	Weighting: 3,0%

INN8 INVEST STABLE GROWTH

Performance Snapshot - 30 September 2022

*HOVER TO SEE MORE INFORMATION

Performance attribution

Returns (net of fees)	3 m	1 yr	3 yrs	5 yrs
Inn8 Invest Stable Growth	1,1%	3,1%	7,4%	6,9%
ASISA South African MA Low Equity peer average	0,5%	1,5%	5,4%	5,2%
CPI +2% (1 month lag)	*3,3%*	*9,8%*	*7,3%*	*7,1%*

Source: Morningstar. Returns are net of fees.

Performance drivers over the past three months

	What helped?	What detracted?	Comments
Asset allocation	• Underweight SA and Global Property	• Overweight SA Equity	• The solution had another good quarter. Truffle drove returns, stock selection in ABSA, Thungela and Exxaro helped its performance. Coronation and Abax also did well out of their high offshore exposure. Amplify struggled while Ninety One's hedged offshore exposure hurt. Despite some of the managers struggling, the solution still outperformed.
Manager selection	• Truffle Flexible	• Amplify SCI Defensive Balanced	

How is the Solution positioned?

Equities	Bonds	Property	Cash	Global
Weighting: 31,9%	Weighting: 50,4%	Weighting: 2,6%	Weighting: 15,1%	Weighting: 17,9%

INN8 INVEST MODERATE GROWTH

Performance Snapshot - 30 September 2022

*HOVER TO SEE MORE INFORMATION

Performance attribution

Returns (net of fees)	3 m	1 yr	3 yrs	5 yrs
Inn8 Invest Moderate Growth	0,8%	2,6%	7,7%	6,4%
ASISA South African MA Medium Equity peer average	0,1%	0,8%	6,0%	5,0%
CPI +3% (1 month lag)	*3,6%*	*10,8%*	*8,3%*	*8,1%*

Source: Morningstar. Returns are net of fees.

Performance drivers over the past three months

	What helped?	What detracted?
Asset allocation	• Underweight SA and Global Property	• Underweight SA Cash • Overweight SA Equity
Manager selection	• Truffle Flexible	• M&G Inflation Plus

Comments

- The solution was ahead of its benchmark in Q3.Truffle drove returns, stock selection in ABSA, Thungela and Exxaro helped its performance. Coronation and Abax also did well out of their high offshore exposure. M&G struggled as it has a core holding in ILBs and had interest rate sensitive companies. Laurium also struggled as it held more than 70% in equities. Despite some managers struggling, the solution still performed well.

How is the Solution positioned?

Equities	Bonds	Property	Cash	Global
Weighting: 47,6%	Weighting: 38,4%	Weighting: 2,8%	Weighting: 10,7%	Weighting: 23,0%

INN8 INVEST HIGH GROWTH

Performance Snapshot - 30 September 2022

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Performance attribution

Returns (net of fees)	3 m	1 yr	3 yrs	5 yrs
Inn8 Invest High Growth	0,3%	1,8%	9,2%	7,0%
ASISA South African MA High Equity peer average	-0,1%	0,2%	6,8%	5,2%
CPI +4% (1 month lag)	*3,8%*	*11,9%*	*9,4%*	*9,2%*

Source: Morningstar. Returns are net of fees.

Performance drivers over the past three months

	What helped?	What detracted?	Comments
Asset allocation	• Underweight SA Property • Overweight Global Assets	• Underweight SA Cash • Overweight SA Equity	• The solution outperformed its benchmark.Truffle drove returns, stock selection in ABSA, Thungela and Exxaro helped its performance. Bateleur did well out of its asset allocation calls, underweight SA equities and overweight SA cash. M&G struggled as it held interest rate sensitive companies. Despite some managers struggling, the solution still performed well.
Manager selection	• Truffle Flexible	• M&G Balanced	

How is the Solution positioned?

Equities	Bonds	Property	Cash	Global
Weighting: 64,6%	Weighting: 24,6%	Weighting: 2,8%	Weighting: 7,6%	Weighting: 28,2%

INN8 INVEST FLEXIBLE GROWTH

Performance Snapshot - 30 September 2022

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Performance attribution

Returns (net of fees)	3 m	1 yr	3 yrs	5 yrs
Inn8 Invest Flexible Growth	2,0%	-2,4%	9,7%	8,8%
ASISA Worldwide MA Flexible peer average	1,1%	-4,7%	6,1%	5,5%
CPI +5% (1 month lag)	*4,1%*	*13,0%*	*10,4%*	*10,2%*

Source: Morningstar. Returns are net of fees.

Performance drivers over the past three months

	What helped?	What detracted?	Comments
Asset allocation	• Overweight Global Equities • Overweight Global Bonds	• Overweight SA Equity • Underweight SA Cash	• The solution outperformed its benchmark. The biggest drive of returns were the 1nvest passive and Coronation mandates, they did well from high global exposure as the rand soldoff by 11.1%. 36one struggled due to stock selection calls in banks and technology. Despite some managers struggling, the solution still performed well.
Manager selection	• 1nvest MSCI World Idx Fdr Fd	• 36ONE Flexible Opportunity	

How is the Solution positioned?

Equities	Bonds	Property	Cash	Global
Weighting: 77,2%	Weighting: 11,4%	Weighting: 1,5%	Weighting: 9,7%	Weighting: 63,0%

Understanding what diversification is... and what it is not

Joao Frasco
Chief Investment Officer: INN8 Invest

Key Points:

- Diversification remains the one 'free-lunch' in investments, as it is unrewarded, and investors can use it to reduce idiosyncratic risks.
- It applies at many different levels of unrewarded risk, ranging from individual securities, through asset classes, to the manager level.
- It should be measured over multiple periods and over the time horizon of the investor, not over a single period or short-term time horizons.
- It should not be confused with hedging, which should involve assets that behave in exactly the opposite way to each other.

Introduction

Diversification is easily one of the most discussed topics in investments, but it is also one of the most misunderstood. If you think this statement is hyperbolic, consider two misconceptions that are often attributed to the failure of diversification.

1. The first, is when two asset prices move in the same direction over a given period.
2. The second is simply, when two asset prices move in the same direction, irrespective of the period.

Although this may sound like exactly the same thing, they are in fact two distinct elements of diversification that are often misunderstood. Reread any article that discusses the failures of diversification, and you may find one or both elements being misunderstood. Let us explore them in greater detail to understand where the failure occurs.

Understanding diversification

The most important thing to understand about diversification is that it is a continuum and not a binary phenomenon. What do I mean by this? Like most things in investments, you should think about them as continuums between two extremes and avoid the convenience of thinking about them in binary terms. At the one extreme, you have two assets that are perfectly correlated, either positively – they move together, up and down – or negatively, where they move in opposite directions. At the other extreme, they have zero correlation, or move completely independently of each other. This is where the first misunderstanding creeps in. Most people struggle with the simple concept of two assets behaving independently, because they see them move in the same direction and assume that they must be correlated.

> "BUT *what are the options for the behaviour of two uncorrelated assets?*"

If one moves up, what can the other do? If it moves up or down and you assume that it is then either positively or negatively correlated, what then does uncorrelated represent? There is no other option i.e., unless assets do not trade, they will invariably move up or down. The definition of uncorrelated is in fact that they will sometimes move up together and sometimes they will move down together, and these outcomes are effectively equally likely.

Yet people will observe two assets that have moved in the same direction, usually down, over the same period of time and assume that diversification has failed, when the truth could be the opposite i.e. the assets have behaved exactly as predicted – independently, even though they just so happen to have moved in the same direction.

> "AND *here is the catch.*"

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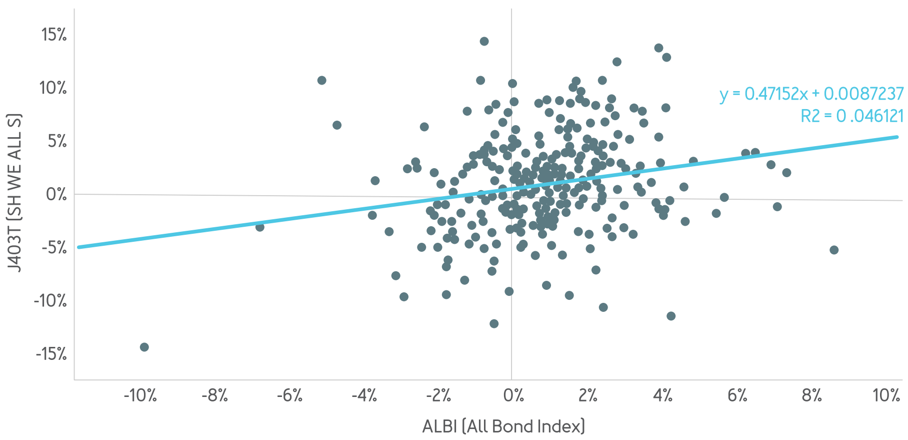
Understanding what diversification is… and what it is not (cont.)

Correlation must be measured over many observations. Technically it is undefined over one observation, say a single day or month, and always plus or minus one (perfectly correlated) over two observations, which makes it meaningless. If you have therefore understood two assets as being uncorrelated, say over time, and then you look at the failure of this diversification over a single observation, you have failed to understand how diversification works.

Let us consider an example to solidify our understanding. The chart below shows the monthly returns of equities relative to bonds over a period of more than 20 years. While the correlation of 0.215 is statistically significantly different to zero, it is not very high, and bonds are generally a great diversifying asset for equities. In March 2020, however, most commentators spoke about the failure of bonds to provide diversification as they fell almost 10% when equities fell about 14%. Unfortunately, looking at a single observation is not meaningful, and you could draw the wrong conclusions about diversification virtues of bonds. For example, in the next worst single month for equities, bonds delivered close to 0% and in the third worst month for equites, bonds delivered more than 4%. This is exactly the behaviour that you would expect from a diversifying asset.

J403T (SH WE ALL S) vs ALBI from October 1998 to August 2022
Monthly return linear regression (r=0.215)



Let us now consider the other misunderstanding. You do not need uncorrelated assets to benefit from diversification. Two assets could be positively correlated – like with equities and bonds above – and still provide diversification benefits, simply because the magnitude of their moves is not identical. This is the case with many shares for example, and represents the benefit of diversifying what is commonly referred to as idiosyncratic risk. Idiosyncratic risk is the risk that is particular to a specific share – as opposed to risk that affects the entire market. It is different to systematic risk, which affects all investments within a given asset class.

Investors can therefore mitigate idiosyncratic risks by diversifying their investment portfolios, as these are, by definition, company specific.

Consider another example of investing in the shares of two banks. While there are many factors that will drive the share prices of all banks, there are also many that will affect banks differently, because they could only apply to individual banks. An example of this would be strategy.

If the shares of one bank drop by say 20%, and the shares of another drop by say 10%, that is diversification. Yes, you have lost money on both, but not the same amount. And if you held the same rand value in each, you would only have lost 15% on average, and in aggregate. You see, if you only held the bank whose shares dropped 20%, your loss would have been 20%, so the diversification worked. If you think that diversification is one asset going up to offset the loss of the other going down, you are confusing diversification with hedging. While both help to reduce overall risk, they are two very different things. Hedging is the act of removing risk – and unfortunately return as they are two sides of the same coin – whereas diversification is reducing risk by taking on additional risk in a different asset that is not perfectly correlated.

INVESTMENT CENTRE

Understanding what diversification is... and what it is not (cont.)

Diversifying the many layers of idiosyncratic risk

So if you now understand what diversification is and how it works, you may recognise that its benefits can be derived by considering diversification at all levels i.e. every little bit of diversification counts. While most managers will espouse the benefits of diversification at the asset class and security level, few will consider the additional diversification benefits to be gained by considering diversification at higher levels, such as at the manager level.

You need to understand that manager risk is not rewarded and you would be well advised to diversify this by investing with multiple managers, whether you do this yourself with the help of an adviser, or through a multi-manager fund – but do not confuse this with a fund of funds as the two are not synonymous.

Conclusion

Do not misunderstand diversification to be hedging and be careful about understanding the benefits of diversification over a single period or over the short term. Diversification should be measured over the same period as your investment horizon and not over a short or single period, unless this happens to be your investment horizon, in which case you should not be invested in risky assets to start.

Also understand the many levels at which you can derive diversification benefits. While this may start at a security level, it should not end there. At the extreme you should diversify single manager risk, especially where managers are taking high conviction positions, because there is a chance that they could be wrong.

Joao Frasco
Chief Investment Officer: INN8 Invest

MANAGER INSIGHTS

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Transformation...progress has been made but investment teams are still lacking

The results/outcome of a survey conducted on transformation within local investment teams

Puleng Kgosimore

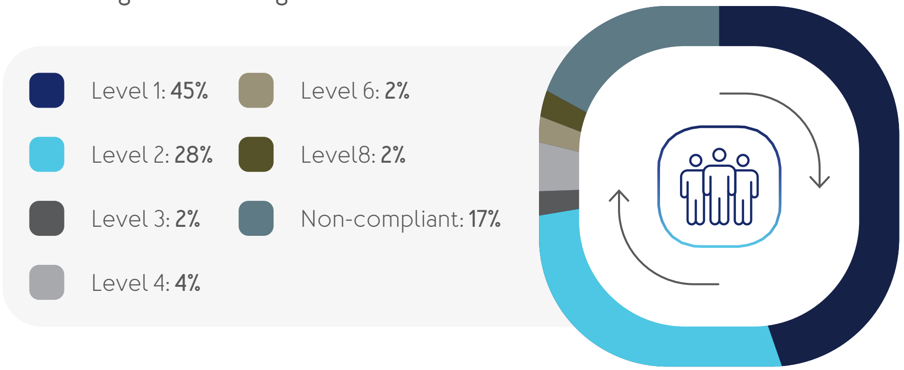
Portfolio Research Analyst: INN8 Invest

Key Points:

- 73% of our survey respondents (47) are level 1 and level 2 BBBEE contributors.
- Only 26.5% of contributors to investment decision-making are female, with better representation in senior non-investment roles.
- Our perception is that race diversity has improved with 51% of investment decision makers being people of colour. But there is still a large gap in the context of South Africa's demographics.

We treasure what we measure and in that context the Broad-based Black Economic Empowerment (BBBEE) targets became a focal point of asset managers, with 73% of asset managers being BBBEE level 1 or level 2 contributors. 17% of managers are non-compliant – most of these managers are those that we would refer to as boutiques managers.

Asset manager BBBEE ratings



Transformation at different levels – but there are gaps

Although transformation is there to pave way for inclusive growth and participation by all, it is more so for those who were previously disadvantaged. There are several positive stories of women or people of colour being appointed to senior roles such as the CEO or Head of Investments.

However, there is not nearly enough of these appointments or specifically, appointments within investment teams, to have moved the dial materially. The target should be an asset management industry where senior management and investment teams closely resemble the demographics of South Africa.

Large gender and race gaps exist in investment decision making

From the analysis of the 47 respondents to our survey, we found a few statistics of concern that point to asset management continuing to be dominated by men.

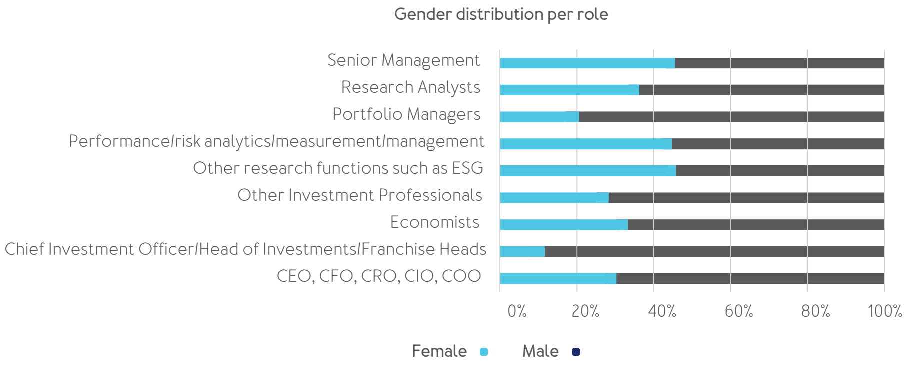
ONLY 26.5% of women contribute to investment decision-making.

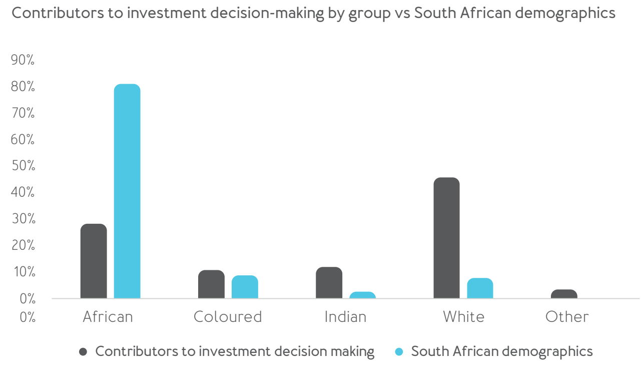
THERE ARE SIX smaller asset managers that do not have a single woman in their businesses.

APPROXIMATELY 80% of portfolio managers are men.

ONLY 12% of CIOs are women.

Transformation...progress has been made but investment teams are still lacking (cont.)





Other (AM) largely represents the foreign nationals in the investment teams.

When assessing race demographics at a high level, it might appear that transformation has improved with 51% of contributors to investment decision-making being people of colour. However, the gap from an African perspective is stark, with only 28% contributing to investment decision making.

From our discussions, some managers cited time as a limiting factor to implementing transformation objectives in their businesses. This is due to issues such as a high staff retention or low team turnover. Scarcity of senior talent, especially of women has also been cited as reasons for not achieving gender parity or transformation in investment teams.

It is disappointing to see that some of the larger asset managers continue to struggle with diversity in their investment teams, with white professionals largely making the investment decisions. These are the institutions that should be championing this level of transformation given their access to resources. The smaller managers that managed to achieve this balance were those that focused on being transformed businesses from the onset, but still with diversity in their teams. By contrast there are four smaller asset managers that do not have neither people of colour or women in their businesses.

How are managers dealing with the challenges?

There are managers who have business initiatives/plans to address transformation as an issue and others that have none. However, we realised that there seem to be a move towards improving internal hiring policies by focusing on EE candidates as first choice of employment. Commendable are those managers who have internship and graduate programs that focus on growing their own timber. This focuses on candidates of colour to address the race and gender challenges in our industry.

Small managers stated that it is also difficult to retain this talent given their demand in the market, and that large managers have a bigger budget to compete for this talent. This supports our thinking that, given their resources, larger managers should have transformed teams.

MANAGER INSIGHTS

*HOVER TO SEE MORE INFORMATION

Transformation...progress has been made but investment teams are still lacking (cont.)

Conclusion

Transformation has come a long way, with previously disadvantaged people given opportunities to own equity stakes or participate in asset management businesses. However, transformation is not only about the level of black ownership or management control in the business. It is also about the individuals within the organisation representing diversity of race and gender.

SOME OF THE REASONS
cited for not achieving diversity include:

- a shortage of - senior female professionals
- low team turnover - implying a lack of opportunities to hire new individuals
- lower budgets - to compete for talent.

Although there are managers who have their own programmes to grow the pool of talent in the industry, there seems to be slow growth of the pool of females and individuals of colour in the roles that matter. If this challenge is not addressed now and sufficient programmes are not put in place, this imbalance will perpetuate for a long time.

Puleng Kgosimore
Portfolio Research Analyst: INN8 Invest

At a glance – our asset class views

Please be aware that there are risks in simply implementing these views into a portfolio without carefully considering the dynamic nature of the environment, how changes impact each asset class and the unique needs of each client.

While our long-term real return assumptions are derived assuming that markets are in equilibrium, we do not believe that this is the case all the time. We therefore take views (tactically over/underweight) on relative asset class performance over three to 12 months, specifically ignoring shorter-term noise and not relying on long-term expectations i.e., we need to see the catalyst for the relative performance.

Domestic SA	Comment	-	o	+
Equities	Neutral – fears of a recession vs attractive valuations		o	
Listed property	Neutral – attractive but facing several headwinds		o	
Bonds	Overweight – long-dated bonds are offering high yields			+
Income*	Overweight – more attractive than cash			+
Money market	Underweight – despite rate hikes, rates remain low	-		

Global	Comment	-	o	+
Equities	Neutral – recession fears vs improved valuations		o	
Bonds	Underweight – US Fed committed to bringing inflation down	-		
Money market	Underweight – the rand offers value at current levels	-		

*Floating rate instruments of maturity longer than one year.

**Views expressed for each asset class are subjective and are for the asset class as a whole. All views are as at 30 September 2022.

Domestic asset classes

Equities

- South African equities, as measured by the FTSE/JSE Capped SWIX Index, had another difficult spell, losing 2.4% for the quarter, bringing the year-to-date loss to 7.0%. Equity markets were cooled off by stubbornly high inflation in most countries, coupled with higher interest rate expectations in the US and more recently, fears of a recession.
- We started the year with an overweight equity position but started reducing this in February. When equities sold off in Q2 we decided to maintain the marginal overweight while looking for opportunities to increase our weighting. Post the US Fed’s meeting in September, we are more concerned that the next shoe may drop when analysts start revising down their earnings expectations.
- We acknowledge valuations look attractive with an 8.1x forward PE, a dividend yield of 5.1% and 1.5x Price-to-Book ratio but prefer to stay neutral for now. We believe there will be another entry point. Having said that, our process is dynamic, and we stand ready to change our view if data dampens our recession fears.

Domestic asset classes (cont.)

Listed property

- The SA-listed property sector struggled in Q3, dropping a further 4,1% and bringing its return to -17% YTD. Property has been at the mercy of the risk-on/risk-off environment seen this year. Overshooting when it is risk-on and selling off more when it is risk-off.
- We remain neutral the asset class. There are arguments for property – a forward yield of 6.7% looks attractive, increasing foot traffic in retail centres and the return-to-work trend are all positive for the property sector. However, we remain concerned about GDP growth, high unemployment, and rising interest rates, all of which are likely to keep returns suppressed.

Bonds

- The bond curve flattened in Q3 with the yield on the R2030 rallying from 10.8% in June to 10.2% in September. On the back of this, SA bonds produced 0.6% in Q3 and have only lost 1.3% YTD.
- Despite the recent rally in the curve with yields coming down and prices going up, it remains very steep. The R2040 is yielding 11.9% while 2-year bonds are also on a healthy 7.2%. Talks of changing the SARB inflation plus target to 3.5% make current yields even more attractive.

Income

- Short-dated bonds rallied 0.7% over the quarter and are up 2.0% for the year, ahead of most asset classes.
- We like the defensive nature of the asset class relative to bonds and it is at an attractive spread of 350 basis points to cash. The historic spread is 40 points.

Money market

- This is our default asset class. We reduced the cash underweight in Q3 in line with our expectations that a recession might be looming. However, we still prefer longer-dated fixed income instruments as they remain more attractive, despite the 250-basis point interest rate hikes by the SARB this year to date.

Global asset classes

Equities

- Global stocks also had a difficult quarter. The MSCI AC World Index dropped 6.1% in US dollar terms in Q3 and is down 25.2% YTD. The initial sell-off early in the year was driven mainly by higher interest rates and the war in Russia which further fueled inflation.
- Global equity markets remain under pressure as earnings expectations may not fully account for the ongoing central bank tightening and increased recession risk. We remain neutral.

*HOVER TO SEE MORE INFORMATION

Global asset classes (cont.)

Bonds

- As in Q2, bonds sold-off again with equities. They lost 6.8% in Q3 and are down 19.8% YTD in US dollar terms.
- The yield on the 10-year US Treasury note sold-off to 3.8% as inflation remained stubbornly high at 8.3% in August and the US Fed confirmed its commitment to bring inflation down. Market views on rates now lean toward back-to-back 75 basis point hikes at the next two Fed meetings, with the expectation that the central bank will push rates past 4.85% before the tightening cycle ends. The current rate is 3.25%.

Money market

- This is our default asset class and is used to increase or decrease our offshore exposure. At this point, we prefer domestic assets to offshore assets. We also think the rand is significantly weak – at the time of writing, the rand was trading at R18.30 to the US dollar.

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