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In 2018, investors were reminded how volatile markets can be. The first few months of 2019, however, would have served to restore your faith in the stock market, provided you had persevered and stayed the course. The All Share Index, despite lagging global equity markets, celebrated its best quarter in more than a decade by rising 7.1%. Many investors have their advisors to thank for convincing them to remain invested.

I recently had the privilege of returning to university for a few weeks. It wasn’t time off, but the time away allowed me the luxury of reflection. For many people, relationships – both personal and professional – are a key determinant of happiness. I had time to consider the enduring relationships we have built with our advisors over the years and, in turn, the relationships they have with their clients. Many investors would have needed a solid partnership with their advisor to navigate the turbulence of recent years. I appreciate that this time away allowed me to acknowledge and be grateful for the strength of these trusted relationships.

The other benefit of being away from my day job was that I was – albeit briefly – removed from the daily political and economic noise. Being confronted non-stop by currency and market fluctuations, and political rhetoric (especially in the lead-up to a general election) only serves to distract from long-term investment goals.

**Corrections** happen on average once a year.
So, stripping out the noise, what lessons can we learn about markets from the gains over the first quarter and the dreadful final quarter of 2018? We now know that the drawdown at the close of last year was a correction (a short-duration market decline greater than 10% but less than 20%) rather than the start of a bear market. Research by Jeff Desjardins titled *The Anatomy of a Market Correction,* which analysed US market data from 1980 to 2018, provides some fascinating insights into corrections.

Firstly, corrections happen on average once a year. It lasts approximately 76 days and generally the average decline is in the region of 15.6%. Historically, only 14% of corrections signalled the start of a prolonged downturn.

Most tellingly and providing yet more evidence that investors should not be distracted by short-term news flow, the report demonstrates it’s time in the market that counts rather than trying to time the dips. Relating this back to the South African context, by timing the dips investors generally miss the best days. In fact, if an SA equity market investor were to have missed the 20 best days since 1999, their return would have been less than half (5.15% p.a.) of what it would have been if they had remained invested (12.48% p.a.) over the 20-year period!

With so much noise assaulting us daily, real investment insight is rare. I am privileged to share with you in this edition of *Taking Stock* thought leadership from Philip Saunders and Sahil Mahtani, which explores themes that are set to fundamentally change the way we approach investment. Their article on de-dollarisation focuses on the ongoing moves to erode dollar dominance and the shift to a multi-currency international monetary order.

John Stopford and Jason BORBora-Sheen cut through the Brexit noise and consider how to position portfolios against the backdrop of trade wars, fears of a recession, and the maturity of the business cycle.

Our research into living annuities has also elicited many additional questions from our advisors and in this issue, we unpack the merits of bucket strategies. While they may feel intuitively ‘right’, our research reveals that they are not a silver bullet portfolio management technique.

With the election also now successfully behind us, this edition includes both Nazmeera Moola and Jeremy Gardiner’s views on what the future holds for our beloved country.

In conclusion, we still haven’t seen real investment return to the stock market – despite the bullish start to 2019. Household deposits are sitting at approximately R1.2 trillion today, up from R700 billion three years ago. We need to help investors identify the long-term opportunity and convert that cash into real investments.

We, along with advisors, have a duty to aid investors find solutions for a better tomorrow. While we have written many articles to help them achieve their investment goals, we also want to reiterate that we are available to assist in any way that can add value.

With the SA market finally having shown signs of life, I am reminded of the old saying: if not now, then when? If not you, then who?

Thank you for your continued support.

Sangeeth Sewnath
Deputy Managing Director

*https://www.visualcapitalist.com/anatomy-market-correction/*
Oops, Trump did it again!

JEREMY GARDINER

2018 started so well. We had been spared an additional eight years of another Zuma presidency and we had a great new leader in Cyril Ramaphosa. Finally, we could start fixing the country.

Then suddenly in April, ‘Ramaphoria’ went out the window, our currency dived, the petrol price rocketed, growth slowed into recession and the stock market got hammered. South Africans blamed our politics and corruption, when in fact, the same scenario was playing itself out across most emerging markets worldwide. The reason, very simply, was that Trump had declared economic war on the Chinese. Globally, analysts seemingly concluded that tariffs of 25% on all Chinese exports to America were likely to significantly dent the Chinese, and therefore all emerging market growth, and they dumped emerging market assets. In May last year, foreign investors sold more South African bonds than ever before in one month.

2019 feels eerily similar. Finally, awoken from their five-year slumber, equity markets have been spurred on by a seemingly imminent end to the tariff war. Despite Eskom and corruption, a bumper first quarter was followed by an equally exciting beginning to the second.

Markets held their ground as political noise levels rose.
Then came elections, but markets held their ground as the noise levels rose. And there were legitimate fears – the ANC could easily have been punished hard for the last nine years, in which case it would have needed alliance partners, which could have seen EFF populism dictating government policy. A poor showing for the ANC could ironically have been blamed on Ramaphosa, leaving him with a weakened mandate, and even possible ejection. In the end we got the perfect result – the people forgave the ANC for the past nine years and voted for the President because they like him, giving him a strong enough mandate to do what now needs to be done. The EFF got less than it could have and won’t be needed as an alliance partner (a kingmaker) this time, meaning that despite its improved showing, the EFF is not in government anywhere.

The big fear pre-elections was that a faction within the ANC was going to remove Ramaphosa as president shortly after the elections. We put this question to the country’s top five political analysts, and almost without exception they said it was highly unlikely, if not impossible. In their view, those rumours had been circulated by opposition parties to stop people voting for the ANC. So with President Ramaphosa in place, at least until 2022, can we finally start fixing this country, end corruption and create jobs?

What would really help him in this quest are some macro tailwinds in the form of emerging market strength, which had already begun. Whether it continues or not, I’m afraid, lies in the hands of Donald Trump. The good news is, he has an election coming up in 18 months’ time, for which he needs a strong economy and stock market, both of which will be hurt by a tariff war. Although there is speculation that part of the reason he is doing this, is that by increasing risk aversion and depressing asset prices, he will force the Chinese to stimulate more and the US Federal Reserve to drop rates. This would push US stock markets and growth to record highs, just in time for elections.

In addition, the Chinese have hit back with tariffs of their own, targeting products made in Trump-supporting states, which will greatly annoy the soybean farmers, and will hurt at elections. And finally, in two to three months’ time, American consumers will suddenly realise that it’s actually not the Chinese who are paying for the tariffs, but the Americans, with prices for everything from smartphones to televisions, rising by 25%.

This will annoy them, but Trump knows this and can’t risk upsetting them before elections. So expect more Chinese stimulus, possibly even a US rate cut, and then ultimately, hopefully, a US-China deal, all of which should be favourable for emerging markets, including South Africa.
Can we finally start **fixing** this country, end corruption and **create** jobs?
South Africa is at a crossroads

A week after South Africa’s fifth democratic election and the election results reveal that the country has made the pragmatic decision. Voters have given the ANC a sufficient majority to comfortably form a government, both nationally and in the eight provinces it previously ruled.

In the run-up to the election two questions took centre stage. First, would Cyril Ramaphosa gain a big enough endorsement to implement reform? The consensus view was that a number around 56-58% would be sufficient. The ANC achieved 57.5%, thus providing Ramaphosa with the mandate he requires.

Second, would the ANC be able to hold on to Gauteng, South Africa’s economic heartland, by itself, or would it need to form a coalition with the EFF to retain control of the province?

The longer-term outlook will be determined by the choices SA makes.

NAZMEERA MOOLA
Head of SA Investments
When it became clear that the ANC would not have to cut any deals with the EFF, markets rallied strongly. In the midst of a Trump and China-driven wobble in emerging market currencies and equity markets, both the rand and domestic South African stocks strengthened.

While the short-term boost is welcome, the longer-term outlook will be determined by the choices South Africa now makes.

South Africa is at something of a crossroads. After a decade of sub-par growth, erratic policymaking and widespread private and public sector corruption, the status quo is not sustainable. If the government remains unable to make hard decisions, growth will continue to be insipid and expenditure will remain excessive. Growth at around 1% is insufficient to stabilise government debt levels.

Unfortunately, there is a growing risk that the global environment may become distinctly unhelpful. Jacob Zuma was allowed to propagate his profligate spending and rampant corruption because plentiful global liquidity in the aftermath of the global financial crisis resulted in massive foreign inflows into South Africa’s bond market.

The country has a **deep** local savings pool that can **fund** the budget deficit.

Quantitative easing meant that for a number of years, markets have failed to do their job in South Africa. Instead of punishing South Africa for its deteriorating budgetary fundamentals, money continued to pour in, allowing the government to issue large amounts of debt. Awash with cheap money, the foreign ownership of the local bond market rose from 7% in 2008 to a peak of 48% in mid-2018.

In the late 2018 sell-off in markets, foreign ownership in South Africa declined to 38%. Fortunately, the country has a deep local savings pool that can fund the budget deficit. However, government borrowing costs have had to rise to attract sufficient funding. If global conditions turn more unfavourable, they will have to rise further, diverting an increasing share of government spending to interest payments.

For now, global conditions are neutral. By global conditions I mean the combination of the growth outlook and the liquidity outlook. Growth looks okay, although the April Chinese data was mixed. Chinese growth is key for commodity exporters like South Africa. Global liquidity received an enormous boost when the US Federal Reserve kept interest rates on hold during the first four months of the year. The central bank’s move effectively halted the sell-off in markets. However, if inflation returns as a concern, US interest rates may well start rising again.
Against an uncertain global outlook, it is key that South Africa takes all the measures it can to insulate itself by boosting confidence, investment and growth.

The first post-election signpost to South Africa’s prospects will be the shape of the new Cabinet. Will it be cut down from 35 to 25 ministries? Will there be a clean-up of those ministers implicated in state corruption? Will capable people be appointed? The President is due to be sworn in on 22 May. While the timing is not entirely clear, the cabinet should be announced by then.

In late 2022, the ANC will hold its next electoral congress. That gives Cyril Ramaphosa the next three years to tackle the ills that Jacob Zuma inflicted on the country. If he doesn’t manage to get growth going in that period, the ANC will elect a more radical leadership. That will only be the start – as there is every chance that in mid-2024, the EFF will become the kingmaker.

The EFF’s current policy mix resembles those of Venezuela – emotionally seductive to the economically disempowered, but ultimately unsustainable. Such policies lead to food crises, as we have seen in Zimbabwe and Venezuela. But five more years without growth could well leave us at the point that voters are willing to give it a try.

This article was first published in Daily Maverick on 15 May 2019.
Mounting corporate debt – where will it end?

Since the global financial crisis of 2009, total debt in the US has declined from a peak level of 350% of gross domestic product (GDP) to 311.5% in 2018. While the overall US debt picture has improved, the business sector has been accumulating mountains of debt, thanks to ultra-low interest rates. Corporate debt currently stands at a staggering US$9 trillion, higher than during the global financial crisis. What’s even more concerning is that the amount of US corporate debt sitting just above the ‘junk’ cut-off, has never been as high as it is today. (See Figure 1 overleaf.)

US corporate debt is **higher** than during the global financial crisis.
Figure 1: Market capitalisation of US corporate bonds by credit rating

Source: Gavekal Research data.

The ugly step-sister

The sharp fall in stock markets at the end of 2018 highlighted how vulnerable the financial system is to rising interest rates. The US economy had been racing red hot for over a decade, fuelled in part by ballooning corporate debt and share buy-backs. Signs of a potential downturn in 2018 due to the US Federal Reserve (the Fed) tightening monetary policy, saw debt to GDP ratios shoot even higher. What’s more, credit spreads (essentially the difference between what corporates and government must pay to borrow) blew out, making companies’ debt repayments much more expensive.

We don’t see the sheer volume of bad quality debt as a predictor of when the next recession will hit us. But we believe that when a downturn materialises, it will trigger a tidal wave of corporate rating downgrades from investment grade to ‘junk’ status. The search for yield has seen institutional investors hoovering up these corporate bonds. Large-scale debt downgrades would turn them into forced sellers, with the normally liquid debt market grinding to a halt. Liquidity pressures would spark widespread panic across debt-laden equity and bond markets. We witnessed the start of this unravelling last year, which threw economies and markets into disarray. Corporate debt became the ugly step-sister while defensive assets emerged as the Cinderella of the story.

But things are looking up, aren’t they?

Year to date, the macro outlook seems rosier. In January, the Fed signalled that the US central bank would put further interest rates rises on hold – a complete U-turn from its stance in 2018. What’s more, global growth is softening but still positive, inflation expectations have moderated, and credit spreads have fallen. We’ve seen a strong rebound in markets and risk assets, and the panic surrounding corporate indebtedness appears to have been swept under the rug. So, is it time to stop worrying about corporate debt?
The Fed’s softer monetary policy stance does not change our view on the potential weakness of global financial systems, markets and economies to leverage (high debt levels). Markets will continue to be tested when it looks as if corporate debt is likely to turn bad. There are two primary catalysts for this:

- Rising interest rates, which increase the interest bill that indebted companies must pay.
- Falling profits and margins, which also impact the ability of indebted companies to repay debts.

2018 was the year that investors worried about interest bills eating up corporate earnings and companies defaulting on their debt. These fears triggered spikes in volatility and sudden withdrawals of funds from weak markets, asset classes and companies.

Now that we can breathe a sigh of relief that the Fed is not rocking the boat, our attention should swiftly move to earnings.

**Will corporate earnings be sufficient to pay these debt bills?**

Tax cuts in the US buoyed earnings figures over 2018, but there is no longer such a tailwind going into 2019. This, together with slowing global growth, means earnings growth forecasts are being revised down for 2019 and 2020. Even if US rates remain flat, the cost of servicing debt is higher now than this time last year because of the rate hikes over 2018. If we see a profit squeeze, the most indebted businesses could yet again run into trouble, triggering the same wave of downgrades to ‘junk’ status, which in turn would spark a corporate debt sell-off. Weaker markets, asset classes and debt-laden companies will once again feel the heat.

**Weathering market storms with financially strong companies**

Difficult market conditions and the financial distress they cause are a reality that long-term investors face. The Investec Global Franchise Fund’s strong focus on quality companies with healthy balance sheets has helped our portfolio to remain resilient during challenging times. We seek companies that have the ability to generate strong cash flows and provide sustainable returns over the long term. They typically show low sensitivity to the market cycle, thanks to their enduring competitive advantages, sustainable profits and most importantly, low debt levels. These characteristics mean our quality companies are well placed to weather economic downturns and other financial market stresses.

Their financial strength acts as a buffer, providing operational flexibility in times of market stress. Lower debt levels mean our selected companies are not forced to refinance debt at unfavourable rates. Since inception, the portfolio constituents in our Investec Global Franchise portfolio have shown consistently lower net debt/EBITDA (net debt as a percentage of earnings before interest, tax, debt and amortisations) levels versus the market (MSCI All Country World Index). Currently, the portfolio’s net debt position is approximately zero. (See Figure 2 overleaf.)
Should the Fed change its stance and start a rate-hiking cycle again, the Investec Global Franchise Fund is well positioned to offer resilience. While the market (MSCI All Country World Index) lost 9.4% over 2018, the Investec Global Franchise Fund’s drawdown was limited to -4.5%. Hence, the fund outperformed the index by almost 5%, as shown in Figure 3.
Our portfolio has remained **resilient** during challenging times.

### Table 1: Annualised returns in US dollar as at the end of March 2019

<table>
<thead>
<tr>
<th>Fund</th>
<th>1 YEAR</th>
<th>3 YEARS P.A.</th>
<th>5 YEARS P.A.</th>
<th>10 YEARS P.A.</th>
<th>SINCE INCEPTION P.A.*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investec Global Franchise A ACC</td>
<td>9.9%</td>
<td>9.3%</td>
<td>8.2%</td>
<td>13.0%</td>
<td>6.8%</td>
</tr>
<tr>
<td>MSCI AC World NR**</td>
<td>2.6%</td>
<td>10.7%</td>
<td>6.5%</td>
<td>11.8%</td>
<td>4.3%</td>
</tr>
<tr>
<td>Active Return</td>
<td>7.3%</td>
<td>-1.3%</td>
<td>1.8%</td>
<td>1.2%</td>
<td>2.5%</td>
</tr>
<tr>
<td>GIFS Global Large-Cap Blend Equity</td>
<td>-0.7%</td>
<td>7.7%</td>
<td>3.7%</td>
<td>8.6%</td>
<td>2.0%</td>
</tr>
<tr>
<td>Quartile Ranking</td>
<td>1</td>
<td>2</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
</tbody>
</table>

Past performance should not be taken as a guide to the future, losses may be made. Data is not audited. Source: Morningstar, dates to 31.12.18 and 31.03.19, NAV based, inclusive of all annual management fees but excluding any initial charges, gross income reinvested, in US dollar. **The comparative index changed to the MSCI AC World Index from 1 October 2011. Highest and lowest returns achieved during a rolling 12-month period since inception: Feb-10: 54.4%, and Feb-09: -38.7% – Investec Global Franchise A Acc share class (*launch simulation date: 10.04.07). Quartile ranking within the GIFS Global Large-Cap Blend Equity.**

Recognising that the interest bill is materially lower for our quality equity holdings than the overall market, we now turn our attention to profits and growth. We believe that enduring competitive advantages that create barriers to entry and pricing power, and strong free cash-flow generation are vital determinants of the sustainability of a company’s returns and growth prospects over the long term. Our quality businesses have delivered high quality profits over time. With healthy balance sheets and minimal capital requirements for growth, they can convert close to 100% of their profits into free cash flow. Through their disciplined and effective use of this cash, they have generated returns on invested capital (ROIC) well in excess of their cost of capital. Moreover, our companies’ average ROIC is almost double that of the average global company, highlighting their superior profitability profile (Figure 4 – overleaf).
In our view, very few companies exist that can consistently earn attractive returns, with lower than average volatility. This is only possible if a company has an excellent business model, a healthy balance sheet and sound capital allocation. The Investec Global Franchise Fund is therefore a high conviction portfolio of quality franchise companies that can collectively generate attractive growth in earnings and free cash flow, thanks to their financial strength and low capital intensity. What’s more, they are able to do this independently of external factors, such as interest rates and the economy.

**Why top holding Visa fits the bill**

Visa, the largest electronic payment processing network in the world, is an example of a financially strong company generating superior profits and growth. It is our top holding in the Investec Global Franchise Fund. Visa outperformed the market in 2018 by a staggering 25% in US dollars, reinforcing why we believe it is the highest quality company one can own. In what was a very tough market environment, Visa processed more than 124 billion transactions over the year, growing revenue by 12%, generating US$12 billion of free cash flow and returning US$9 billion of this to shareholders. How did the company achieve this?

Visa is what we call a robust compounder. It has a supreme balance sheet with virtually zero net debt. This financial flexibility, combined with its ability to consistently generate high quality earnings through the cycle, means that the company can drive robust profits and growth, regardless of the macro environment. And it is Visa’s enduring competitive advantages that give us a high degree of certainty that it can continue growing and compounding its earnings and returns going forward.
Visa has one of the strongest and most trusted brands within the payments space, with close to 2.5 billion cards in circulation and 52 million merchant locations worldwide. Its advanced processing network is capable of securely handling more than 65,000 transaction messages a second. Visa’s business model is resilient – it earns a fee for every transaction that takes place on its network. While the fee appears insignificant to the card holder, it is substantial for Visa. Most importantly, its business model and attractive economics protect Visa’s margin.

With only 40% of transactions globally processed via credit cards, there is a long structural runway for growth as transactions move from cash to card. Given its sheer dominance in payments, technological innovations, global reach, trusted brand power, and limited operational and financial leverage, we believe this is a business that has the potential to grow earnings by approximately 15% over the next three years.

Conclusion

Do high corporate debt levels still pose a threat to the global economy and stock markets? Absolutely. The Fed’s about-turn on interest rates does not alter our view on the potential weakness of global financial systems, markets and economies due to re-leveraging. Markets will continue to be tested when there are signs that corporate debt is likely to further deteriorate. Although rising interest rates are not a risk for now, we believe investors need to keep a watchful eye on profits and margins.

Against a backdrop of rising corporate debt, we believe that our differentiated Investec Global Franchise Fund, which targets financially healthy companies that have the ability to provide sustainable profits, is well placed to weather economic downturns and other financial market stresses.
Dethroning the dollar – will China lead the charge?

The US dollar has dominated financial markets in the post-war period, but countries across the globe are increasingly taking steps to reduce dollar use in trade and finance. The settled consensus among most market participants is that any shift in the monetary order away from the US dollar will happen gradually and take decades. After six of the last seven years in which the dollar has risen against other currencies, that may be understandable. Moreover, past currency transitions have taken decades, so this one should too. We are less convinced. In our view, several factors point to de-dollarisation gathering pace over the next few years.

What is driving de-dollarisation?

Geopolitical shifts

2018 was potentially a watershed year in which countries in the path of sanctions, like Russia, Iran and to some extent China and the EU, began to accelerate ways to protect themselves from the consequences of using the dollar. A special purpose vehicle, Instex, was created earlier this year by the UK, France, and Germany to permit payments to Iran.
Less surprisingly, Russia shifted $100 billion of dollar-denominated reserves into renminbi, euros and yen last year. In general, the increasing weaponisation of economic sanctions since President Trump’s inauguration (but also before) is driving countries to seek refuge from the long arm of US financial authority.

No country wants their main bank to be fined billions of dollars – as occurred to France’s BNP Paribas in 2015 – for not adhering to another state’s foreign policy. As if to underline the growing doubt in the current monetary order, Commission President Juncker at the last European State of the Union address emphasised, “it is absurd that European companies buy European planes in dollars instead of euros.”

What’s more, emerging Asian economies are looking for ways to reduce the boom-and-bust cycle associated with the dollar, and they may get that opportunity as trade in Asia becomes less dependent on the US. These countries may find it to their advantage to sign swap agreements with the Chinese central bank and conduct trade in the renminbi, which increasingly reflects their trade patterns.

**Structural shifts in China**

Changes in Chinese demographics imply a need to internationalise the renminbi before too long. China’s working age population peaked in 2016 and will decline going forward. That matters because half the increase in Chinese household savings since the 1970s were driven by demographics. Going forward, higher household dissaving will put pressure on the current account. Of course, China would prefer to borrow in its own currency than incur foreign currency-denominated debt in perpetuity – one reason why China continues to internationalise the renminbi. Recent Chinese initiatives to reduce reliance on the dollar include the China-led Asian Infrastructure Investment Bank, the launch of petroyuan oil futures on the Shanghai International Energy Exchange, as well as Belt and Road and the Made in China 2025 strategy.

**Figure 1: China’s vanishing current account surplus**

Source: State administration of Foreign Exchange, 2018.
**Changes in energy market dynamics**

The shale revolution continues unabated in the US, and by 2025, America is set to overtake Saudi Arabia as the world’s biggest oil exporter. Effectively, the US is buying less international crude oil at precisely the same time the Chinese are ramping up purchases, increasing the opportunity for oil exporters to accept other currencies. As the world’s largest importer of crude oil, China would prefer to settle its trade bill in renminbi. Petroyuan futures, launched last year in Shanghai, have already overtaken benchmarks in Singapore and Dubai by volume.

Figure 2: The new crude buyers on the block


**A dollar down cycle**

After spending six of the last seven calendar years on the up, another dollar down cycle may begin this year. Concerns about US twin deficits are re-emerging. Renewed political polarisation in the US, on the right and now increasingly the left, imply budget deficits as far as the eye can see, driven by tax cuts and higher social spending. Congressional Budget Office forecasts show US debt hitting 152% of output by 2048 from 78% today. The US twin deficits will eventually catch up with the expensive dollar, and we could see the currency fall materially in less than two years. Of course, US interest rates still favour the dollar. But there is also every chance that US rates will converge lower.
What will the next global currency shift look like?

The emergence of a genuinely multipolar world will have a profound impact on markets and portfolios. After seven years of a dollar up cycle and a de-rating in emerging market assets, investors should be aware that the nature of the opportunity unfolding could be structural rather than purely cyclical. Given the uncertainties of a currency transition, we have identified three scenarios:

1. **Full renminbi internationalisation** – China’s capital account fully opens over the next decade.
2. **Renminbi regionalisation** – rising renminbi use is concentrated in emerging Asia.
3. **A reduced role for the dollar** – this would ultimately lower US living standards.

It is worth noting that these three scenarios are not mutually exclusive. For instance, it is possible that full Chinese capital account liberalisation occurs during a period of a prolonged dollar decline. Ultimately, we think the most likely scenario is the second one, which we briefly discuss below.

**Scenario two – Renminbi regionalisation**

In the second scenario, China never fully opens its capital account. The renminbi serves as a reserve currency within an Asian trading bloc while the Chinese maintain some capital controls. A renminbi bloc would not only project China’s strength but would be built on strong and complementary trading relationships. We’ve already seen signs of increasing regionalisation, as reflected in China’s Belt and Road initiative and the People’s Bank of China swap agreements with emerging market countries to facilitate trade. So, what are the investment implications?

- Increased regionalisation could lead to a general decline in risk premia in emerging Asia and reduce the boom and bust of the dollar funding cycle.
- The second broad impact is a transformation of Asian emerging market economic cycles. Increased invoicing in renminbi will mean that other economies will trade more in line with China’s economic and financial cycles. This should boost investment strategies that are related to this transformation.

**In conclusion**

None of this is to imply that the US dollar will not remain a key international currency, if not the most important one, for some time to come. Nevertheless, the coming market cycle is likely to be different, for all the reasons discussed above. The rise of a challenger like China that is less willing to subscribe to a US-led order (as Japan and Germany did), is a fundamentally different development. The emergence of a genuine multipolar world will have a profound impact on markets and will affect nearly every asset class. Investors should be aware that the nature of the change unfolding could be structural rather than purely cyclical.

Read the full piece on our De-dollarisation series, which is available on the Investment Institute’s website.
The next global currency shift will have a **profound** impact on markets and portfolios.
Using a bucket strategy to manage living annuity portfolios

This article is a follow-up to our ongoing series on living annuities which focuses on how to maximise a pensioner’s chances of drawing an inflation-hedged income for life.

During our engagements with financial advisors about our research findings on income and portfolio strategies for living annuities, several additional questions were raised. One of the most frequently asked questions pertains to the value of using a ‘bucket strategy’ for a living annuity’s investment portfolio.

In this article we take a closer look at bucket strategies and explore when they can be useful.

What is a bucket strategy?
A bucket strategy for a living annuity entails grouping assets into two or three clusters. Each cluster of assets is assigned a time frame over which that cluster is supposed to generate income for a pensioner.

Bucket strategies do not offer a silver bullet solution.

1www.investecassetmanagement.com/living-annuity-series

JACO VAN TONDER
Advisor Services Director
Here is a simple example. Let’s assume a pensioner has R10 million for their retirement in a living annuity. A possible bucket strategy would be to invest as follows:

01. You allocate 12 months’ income (R500 000) to a money market portfolio (or bucket).

02. You allocate a further three years’ income (R1.5 million) to a more flexible bond and income portfolio.

03. You allocate the remainder of the assets (R8 million) to growth assets such as local and international equities.

04. You only draw the pensioner’s income from the money market bucket.

05. At the end of every year, you top up the money market bucket, i.e. you switch some assets from the flexible bond and income bucket two into the money market bucket.

06. At least once every three years you switch some assets from the growth bucket to top up the flexible bond and income bucket.

Example of a bucket strategy

![Diagram showing the allocation of pensioner's income to a money market portfolio, a flexible bond and income portfolio, and an equity portfolio.]

Although there are many variations on this basic investment strategy (a different number of buckets and different strategies to top up the various buckets over time), the principles are always the same.
How are bucket strategies promoted?

A bucket strategy for a living annuity feels intuitively correct, because it is often promoted in language referencing valid long-standing investment principles, for example:

- Don’t sell a growth asset when the price is depressed just to fund an income – wait until the valuation has recovered.
- Individual units/shares give you growth potential – try to only draw the income and dividend declarations and never the units/shares.
- It is not about what your shares/units are worth – in the long run what is most important is how many shares/units you own.

Because bucket strategies feel so in tune with proven investment principles, many people believe that they are superior strategies for income portfolios. Some commentators have even suggested that by not constantly selling units out of growth assets to fund regular incomes, bucket strategies are guaranteed to outperform more traditional investment strategies (e.g. where income is funded by selling units across the entire investment portfolio).

Unfortunately, bucket strategies do not offer a silver bullet solution. Let’s examine them in a bit more detail, starting with some international research on the topic.

What does current research conclude about bucket strategies?

Various international and local publications have appeared over the past few years investigating whether bucket strategies do in fact improve the performance of an income portfolio. One of the most recent research papers was published by Javier Estrada in October 2018.² He modelled various portfolio strategies, including bucketing strategies, to determine the extent to which they affect the success rates of living annuities.

The paper makes for an interesting, albeit slightly heavy and technical, read but concludes as follows regarding bucket strategies:

“Although this strategy is not devoid of merit, the comprehensive evidence discussed here, from over 21 countries and over a 115-year period, questions its effectiveness.”

Estrada goes further to conclude that bucket strategies are not superior to other strategies, as is often believed. They actually delivered inferior results compared to conventional multi-asset investment strategies during his model testing.

Why don’t bucket strategies produce a better outcome?

Unfortunately, studying the detailed modelling done by researchers such as Estrada and others on this question does not leave one with a simple answer as to why bucketing does not deliver a superior outcome. Sure, the modelling is robust, and the answer must therefore be correct, but modelling does not always aid one’s understanding of the answer in a ‘common sense’ way.

Estrada attempts to explain the results from his modelling by highlighting how bucket portfolios aren’t optimally rebalanced. For example, he mentions that those who use bucket strategies avoid selling equity assets after a market collapse, but they don’t buy more equities after a market downturn.

We can also apply some of the conclusions we reached in our earlier Investec Asset Management research on living annuities\(^3\) to help us understand what is happening with bucket strategies.

In our research paper on optimised investment portfolios we concluded that, for two living annuities with the same start date and paying the same level of inflation-adjusted income, there are only two characteristics of the investment portfolio that determine the annuities’ success:

01. The expected real return of the portfolio; and
02. The expected standard deviation of the real return.

We can now look at our bucket question in more detail. Let’s assume you have two living annuities with identical initial asset allocations and you draw identical income levels over their entire lifetime. Your approach is as follows:

- You manage annuity number 1 according to a bucket strategy.
- You manage annuity number 2 by selling units across the entire portfolio to fund the income.

Under what conditions will these two annuities give you identical success rates?

From our research work, the answer is that the two annuities will only be identical if you manage them to produce the same real return and volatility. And the simplest way to do that? Just constantly rebalance the portfolio for annuity number 2, say, monthly, to match the aggregate asset allocation of annuity number 1. Matching the asset allocations will cause the annuities to have very similar real return and volatility signatures over time, leading to similar success rates.

The answer to successful living annuities lies in smart management of your asset allocation, and not in some unknown additional investment return generated by the bucketing strategy itself.

However, this is not the end of the story.

\(^3\)www.investecassetmanagement.com/living-annuity-series
We are dealing with human beings here – not computer programmes

When it comes to investment strategies, we cannot ignore the human effect. Investment decisions do not happen in a vacuum, and human emotions and behavioural biases persist in every investment decision.

In the case of living annuities, the principles of behavioural finance are ever present in the interactions between the pensioner (who is always anxious about the longevity of their retirement pot and being sufficiently funded) and the advisor (who has a fiduciary responsibility to ensure that the advice delivered is appropriate for the pensioner). The classic traps of switching between cash and equities at the wrong time, or even having an overly conservative investment portfolio, are ever present with living annuity pensioners.

This is where bucket strategies add their value. Many advisors will attest to the fact that it is much easier to talk a pensioner out of making unwise portfolio changes driven by fear or greed if the bucket strategy is used, as the next three years’ income is always secure in their respective income buckets. Bucket strategies undeniably reduce the risk for behavioural portfolio management mistakes in a living annuity, and therein lies their biggest value to advisors.

Conclusion

A bucket strategy is not a silver bullet portfolio management technique that is guaranteed to generate additional investment returns if followed blindly. It just represents one way to manage the asset allocation in a living annuity and has its own pitfalls. The major factors driving the success of a living annuity portfolio remain:

- The real return of the portfolio (having enough equities); and
- The volatility of the portfolio (managing investment risk).

Getting the asset allocation wrong in a bucket strategy will be as devastating as with any other portfolio strategy.

However, bucket strategies do have their uses. If implemented responsibly, they can help advisors minimise behavioural portfolio management mistakes. Advisors can use bucket strategies for vulnerable living annuity pensioners, particularly those who started their annuities with initial incomes in the ‘income danger zone’ of more than 5% p.a. of pension capital. Bucket strategies can help these pensioners to maintain the correct long-term asset allocation, which ultimately is the most important driver of the success of a living annuity.

In the next article we will look at the common pitfalls when implementing a bucket strategy for living annuity investors, and how to avoid them.

*www.investecassetmanagement.com/living-annuity-series
The clock is ticking

The rally across asset classes at the beginning of this year has delighted many. But market observers have noticed the caution among investors – calling this a “flowless” rally. With memories of 2018 still painfully fresh, it’s understandable why some investors are holding back from jumping into the risk-on environment. We are after all well into a very mature business cycle with recession alarm bells ringing – the clock is ticking.

However, hesitancy and uncertainty can be good news for cautious optimists like us. We’re not suggesting now is the time to get rampantly bullish – it is too late for that. Rather than sluggish at the punchbowl, we suggest enjoying a ‘glass half full’ while there’s still some time left at the party.

Borrowed time

Looking back to the last quarter of 2018, markets were pricing in a rising probability of a global recession by this time in 2019. Now there’s renewed optimism across asset classes, with some predictions saying this cycle could have another leg in it. It’s as though the clock’s been wound back from a few minutes to midnight to perhaps 10 o’clock. What’s the cause of this ‘about-turn’ optimism?
We think the reasons come down primarily to policymakers. Central banks have been rolling back from taking the punchbowl away. If policy was one of the things that took markets lower in the last quarter of 2018, the swing in policy rhetoric, and consequent action, was one of the main reasons why the market cheered coming into 2019. It goes to show how important the attitude, and actions, of the hosts are to the success of a good party.

Delving into the two dominant demand engines, the US and China, we can trace back to the time when the US Federal Reserve (the Fed) said there was going to be two or three interest rate rises in 2019. Now the central bank may lower rates, depending on how economic growth goes this year. In China, the risk of a hard landing is being diminished thanks in large part to considerable structural and fiscal improvements by the government. Why the policymakers have geared into action is clear – the macro picture has deteriorated, with worse-than-expected data supporting the notion that we may be on borrowed time.

**How long have we got?**

Just how much borrowed time we have, and how successful policymakers’ tinkering has been, is still unclear. We’re now seeing one or two green shoots, notably in China itself, in much stronger credit data, recent improved Purchasing Managers’ indices and other leading indicators suggesting that the worst of the global slowdown is near.

But there’s a dichotomy here. On the one hand, everyone’s drinking from the punchbowl with optimistic indicators supporting a healthy economy such as the US jobs report in March, which consequently beat expectations with 196 000 jobs added. On the other hand, an inverted US yield curve has raised fears that, if history is a guide, a recession is highly likely in the next 12-18 months.

So the question remains, is this a durable recovery or more of a temporary upswing within a maturing business cycle? This is what markets and investors are wrestling with. The answer to which greatly determines whether you’re still at the party or cautiously heading for the exits. In our view, it’s getting late and no one wants to be the last person standing, but there is definitely room for a last dance. How this translates into portfolio positioning is all about timing.

**Investec Multi-Asset Income portfolio positioning: the last dance**

If our dance had a name, perhaps ‘vigilant quick step’ would do – we’re aiming to be relatively cautious, while taking advantage of the opportunities in the market.

For example, we think that the Fed has shifted away from just tightening “whatever happens” to a much greater focus on swings in data and in financial conditions. Moreover, we believe that bonds should revert to being more negatively correlated to equities, which they weren’t last year. This makes them a more useful diversifier within portfolios. They allow you to increase equity exposure by adding some duration as an offset in markets where yields are relatively attractive and where interest rates could be cut in the future, for instance US Treasuries.
Options continue to be very interesting because they remain attractively priced, implying that investors see little risk of uncertain outcomes in the future, which is what options basically insure you for. So you pay little for that insurance, and you can use them to participate in market upside if it happens, but avoid market downside. It seems to us that you could easily paint a picture where equities could be up 20% in a year or down 35-40% and so options are a perfect way of playing that uncertainty at relatively low cost.

Let’s not forget how late in the cycle it is. Historically, equity markets peak about six to nine months ahead of a recession. So if it is 18 months away, you need to be thinking about how you might begin to exit and the mix of assets that you hold to insulate the portfolio from volatility and the big unknowns.

We continue to actively manage the risk within the portfolio.

Even if no recession is imminent, it is prudent to manage the portfolio to withstand a range of possible risk events that could transpire over the coming year. We’ve been here before. Uncertainty surged in the lead up to the Brexit referendum in June 2016. While no one could predict which way the vote would go, we were convinced that the outcome would have a significant market impact in either direction, and so we chose to temporarily scale down exposure until the result was known. To do so, we hedged out some of our equity exposure, reduced our sterling exposure and increased bond holdings, prior to the referendum. The net impact was that the portfolio remained flat over the referendum result, when equities fell 8%. Thereafter we unhedged the portfolio and participated in what turned out to be a surprisingly strong rally in risk assets after the initial uncertainty began to fade away.

Similarly, in 2018 we reduced the portfolio’s sensitivity to tighter monetary policy and reduced exposure in the ‘melt-up’ euphoria early in the year. We also responded to the rising recession risk as the year progressed, helping the portfolio to avoid much of the drawdown in markets over the period but especially during the last quarter of 2018.

Uncertainty remains high as we move through 2019. We continue to actively manage the risk within the portfolio by focusing on the best ideas at a security level to capture the opportunities that the market still presents. Given our risk and return objectives, the overall mix of exposures is well diversified by sensitivity to the economic cycle, so everything isn’t going up and down at the same time; exposure to known risks such as the uncertainty around Brexit is limited; and we actively manage the risk behaviour of the portfolio to changing market conditions.

The clock is ticking.

We aim to be prepared, coats on, keys in hand and dignity in check, when the time comes.
Core fund range

Note: [ ] indicates maximum in equities. *As an internal limit, the Fund will normally invest no more than 40% of its value in the shares of companies. The Investec Global Multi-Asset Income, Investec Global Strategic Managed and Investec Global Franchise Funds are available as ZAR feeders. The Investec Global Strategic Managed and Investec Global Franchise Funds are available in hedged GBP classes.
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