Benchmark Retirement Fund

Volume 11, No. 08,
August 2015

MONTHLY REVIEW OF PORTFOLIO PERFORMANCE TO 31 AUGUST 2015

By T H Friedrich – Managing Director, Retirement Fund Solutions Namibia (Pty) Ltd

The monthly review of portfolio performance, as set out in this issue, is also available on our website at www.rfsol.com.na.

1. Review of Portfolio Performance

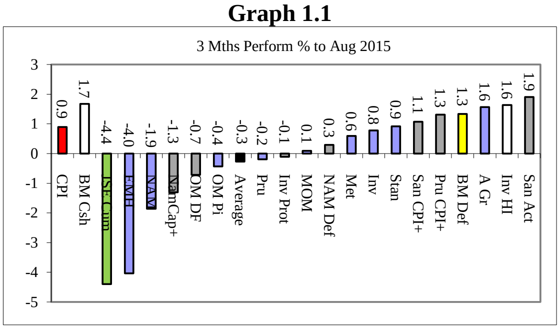
In **August** the **average prudential balanced portfolio** returned -0.83% (July: 1.53%). Top performer is Allan Gray (0.80%); while Momentum (-1.53%) takes the bottom spot. For the 3 month period Allan Gray takes top spot, outperforming the 'average' by roughly 1.9%. On the other end of the scale EMH Prescient underperformed the 'average' by 3.7%.

Graphs 1.1 to 1.7 reflect the performance for periods from 3 months to 10 years of a number of the most prominent prudential balanced portfolios (blue bars), 'special mandate portfolios' with lower volatility risk (grey bars), fixed interest portfolios (no color bars), the average of prudential balanced portfolios (black bar), the JSE Allshare Index (green bar), and the CPI (red bar). Benchmark investors should take note of the performance of the default portfolio (yellow bar), which now represents a combination of Prudential Namibia Inflation Plus and Allan Gray Namibia Balanced Fund.

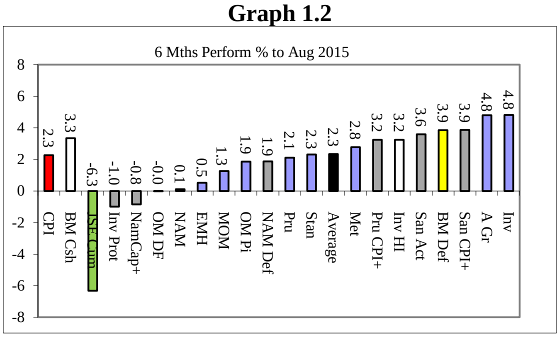
Below is the legend to the abbreviations reflected on the graphs:

Benchmarks	
Namibian Consumer Price Index	CPI (red)
JSE Allshare Index	JSE Cum (green)
Benchmark Default Portfolio	BM Def (yellow)
Average Portfolio (prudential, balanced)	Average (black)
Special Mandate Portfolios	
Money market	BM Csh (no color)
Investec High Income (interest bearing assets)	Inv HI (no color)
Investec Protector	Inv Prot (grey)
Prudential Inflation Plus	Pru CPI+ (grey)
Old Mutual Dynamic Floor	OM DF (grey)
Sanlam Active	San Act (grey)
Sanlam Inflation Linked	San CPI+ (grey)
NAM Capital Plus	NamCap+ (grey)
NAM Coronation Balanced Def	NAM Def (grey)
Market related portfolios	
Allan Gray Balanced	A Gr (blue)
EMH Prescient Balanced Absolute	EMH (blue)
Investec Managed	Inv (blue)
Prudential Managed	Pru (blue)
Metropolitan Managed	Met (blue)
NAM Prudential Balanced	NAM (blue)
Old Mutual Pinnacle Profile Growth	OM Pi (blue)
Momentum Managed	MOM (blue)
Stanlib Managed	Stan (blue)

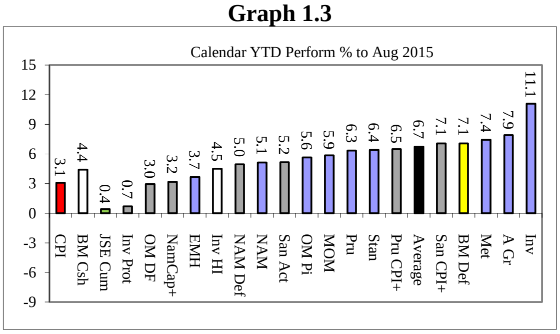
Graph 1.1



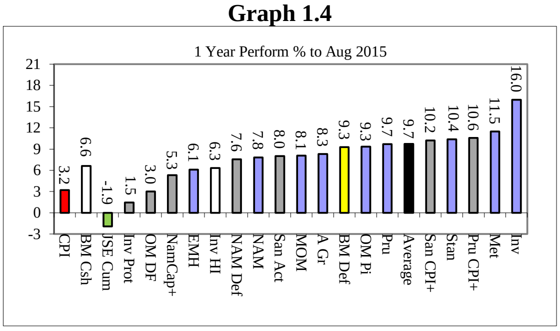
Graph 1.2



Graph 1.3



Graph 1.4



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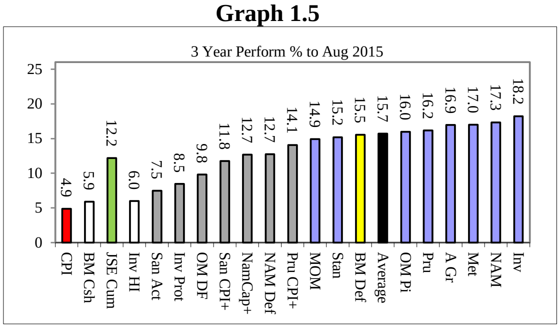
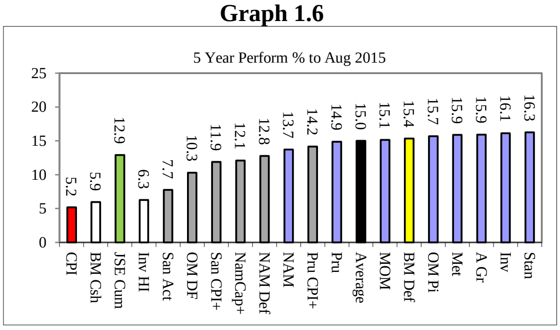
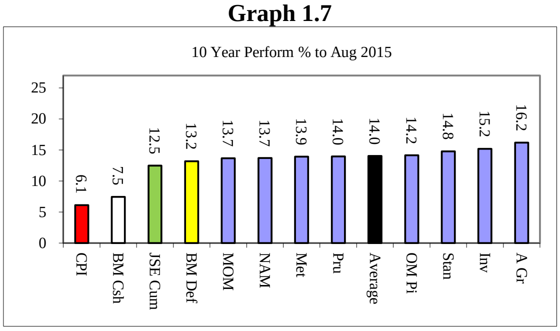
Graph 1.5



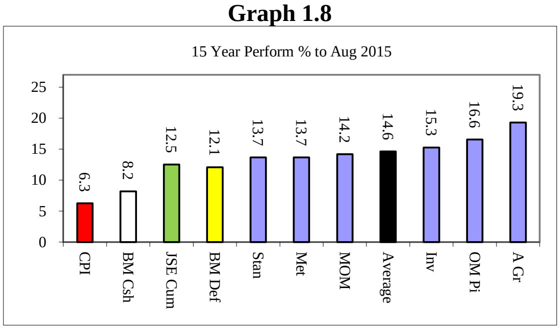
Graph 1.6



Graph 1.7

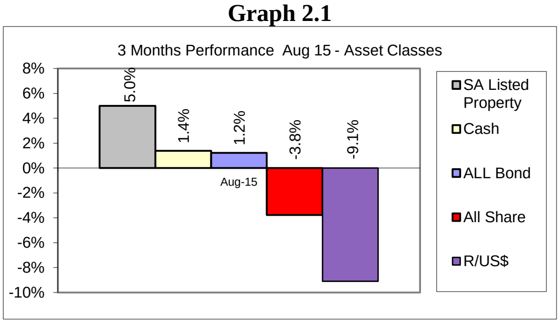


Graph 1.8

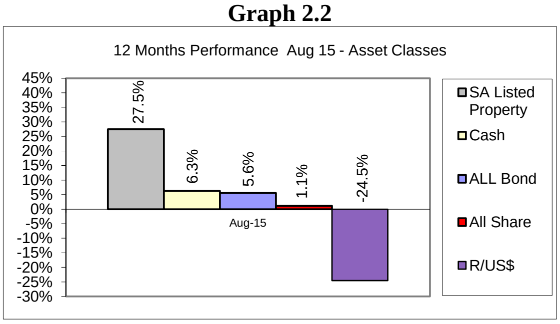


2. Performance of Key Indices (index performance by courtesy of IJG/Deutsche Securities)

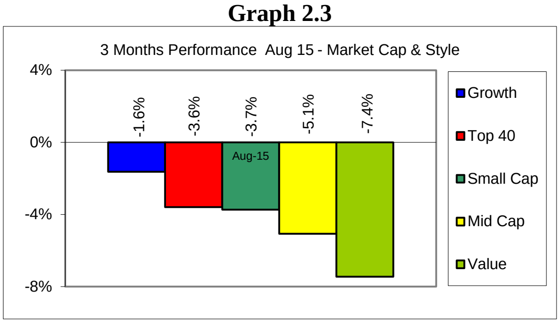
Graph 2.1



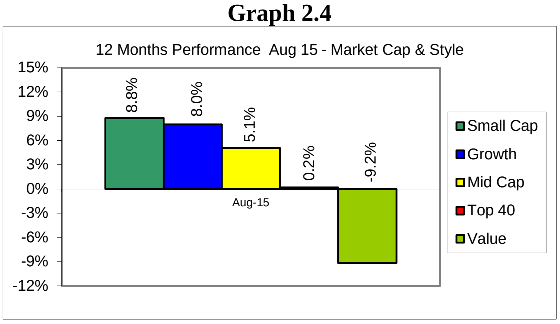
Graph 2.2



Graph 2.3



Graph 2.4



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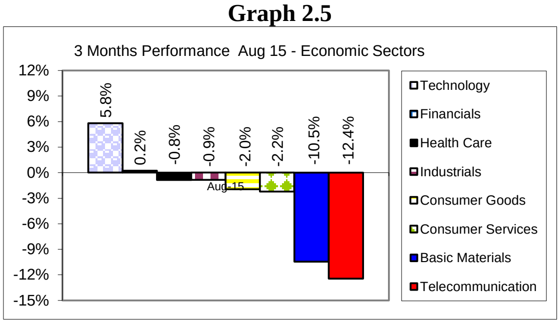

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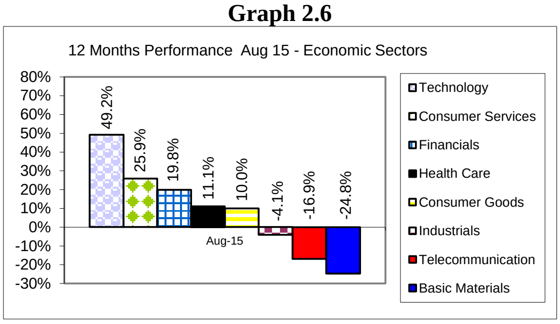
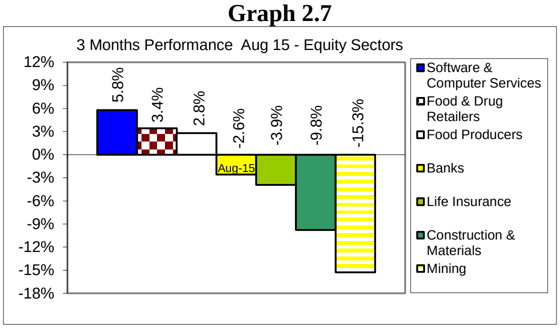
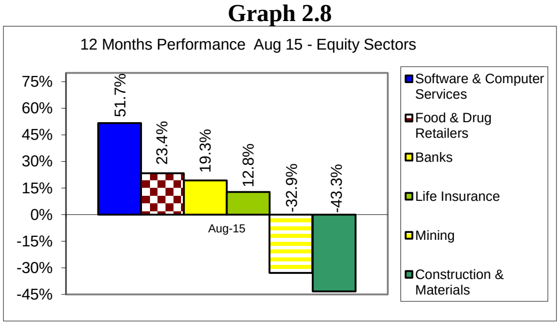


Graph 2.7



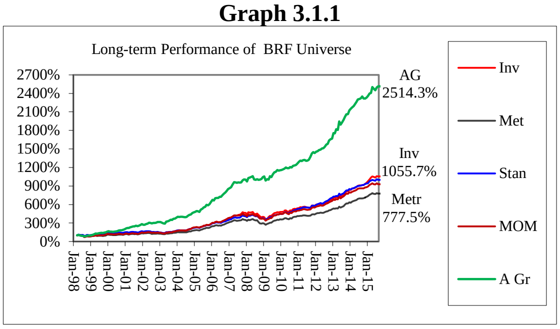
Graph 2.8



3. Portfolio Performance Analysis

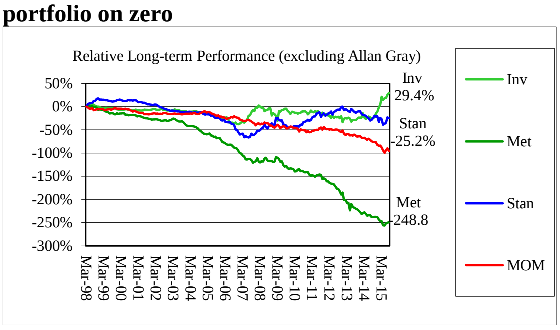
3.1. Cumulative performance of prudential balanced portfolios

Graph 3.1.1

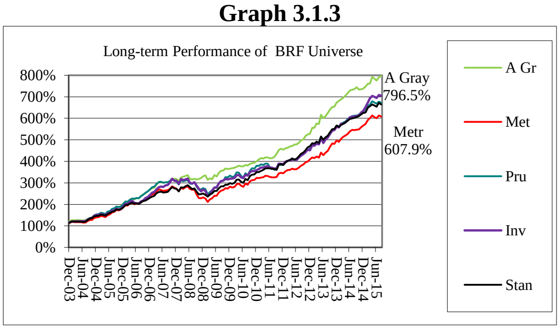


Graph 3.1.2

Cumulative performance of prudential balanced portfolios relative to average prudential balanced portfolio on zero

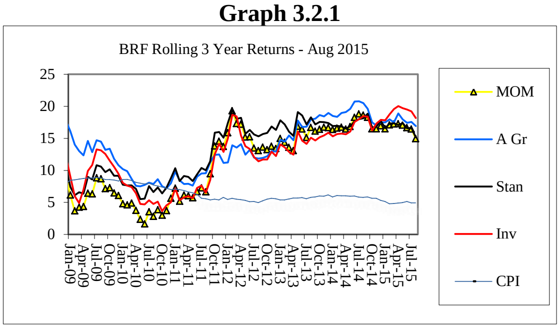


Graph 3.1.3



3.2. 3-year rolling performance of prudential balanced portfolios relative to CPI

Graph 3.2.1



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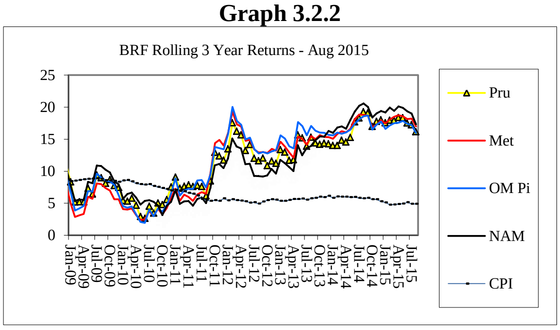
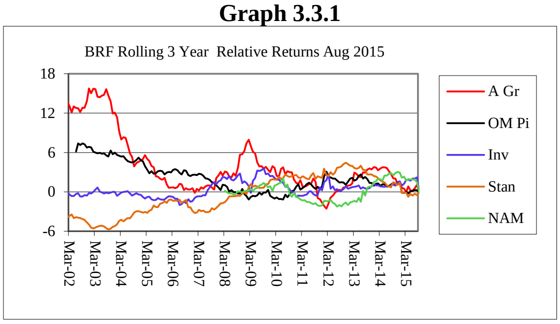
Graph 3.2.2

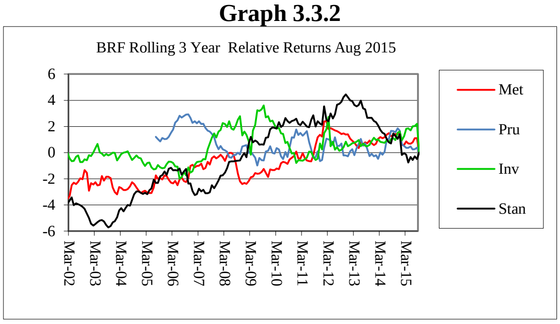


3.3. 3-year rolling performance of prudential balanced portfolios relative to average prudential balanced portfolio on zero

Graph 3.3.1

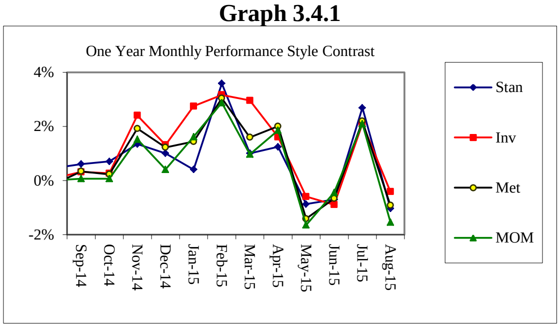


Graph 3.3.2

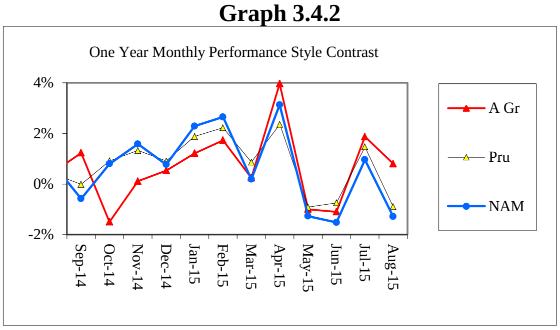


3.4. Monthly performance of prudential balanced portfolios

Graph 3.4.1

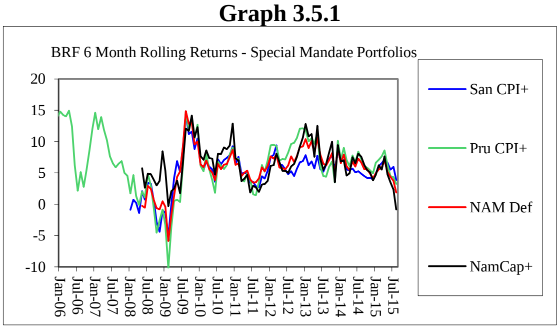


Graph 3.4.2

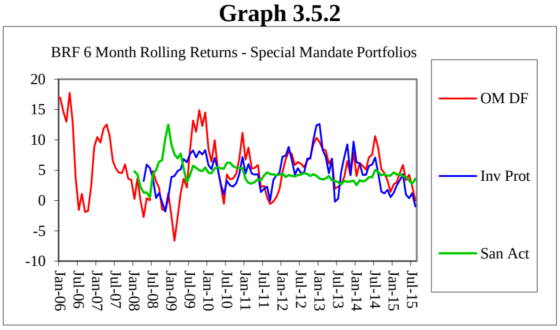


3.5. 6-month rolling returns of 'special mandate' portfolios

Graph 3.5.1

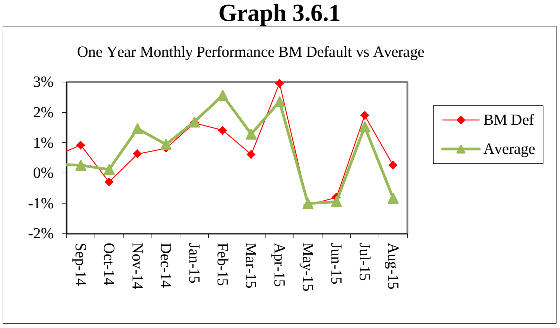


Graph 3.5.2



3.6 Monthly and cumulative performance of 'Benchmark Default' portfolio relative to average prudential balanced portfolio

Graph 3.6.1



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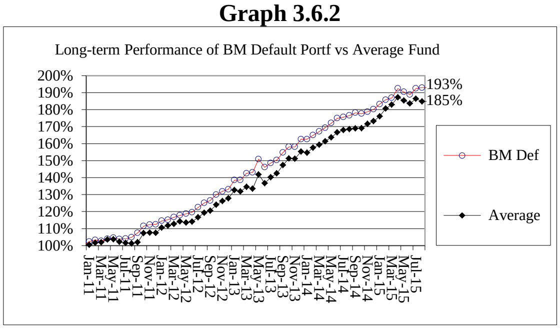
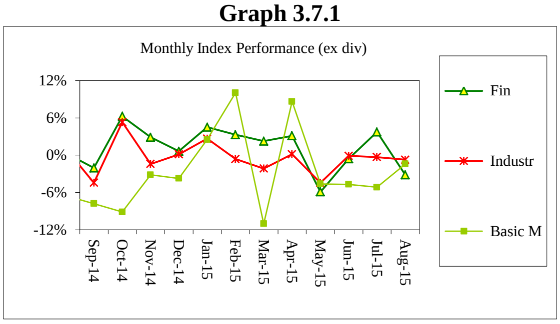
Graph 3.6.2

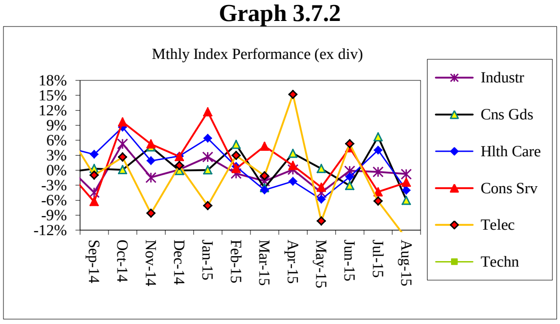


3.7 One year monthly performance of key indices (excluding dividends)

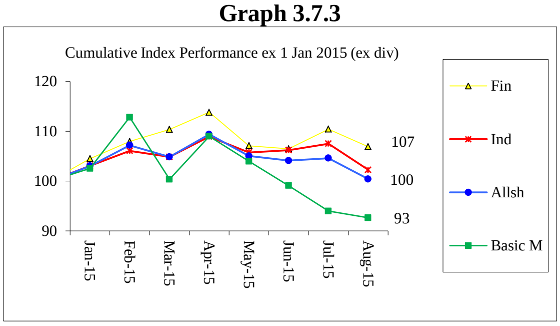
Graph 3.7.1



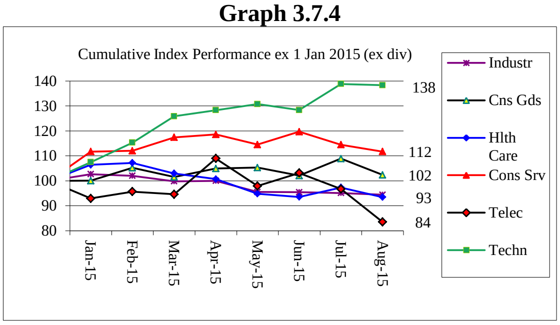
Graph 3.7.2



Graph 3.7.3



Graph 3.7.4



4. The Benchmark Default Portfolio

Graph 1.6 shows that the average prudential balanced portfolio returned 15.0% p.a. in nominal terms, or 9.8% p.a. in real terms, over the past 5 years while the Benchmark Default portfolio returned 15.4% p.a. in nominal terms, or 10.2% p.a. in real terms. The Benchmark Default portfolio is designed to produce a less volatile performance but also lower returns than the average prudential balanced portfolios with its significantly lower equity exposure (47.3% vs. 62.0% of the average prudential balanced portfolio, as at the end of June 2015) and the lower risk it consequently entails for the investor. It should be expected to underperform the average prudential balanced portfolio at times when shares outperform other asset classes and vice versa.

Considering that the average prudential balanced portfolio should deliver a real return before management fees (typically 0.75%), of roughly 6% per year, these portfolios are currently exceeding the expected long-term goal significantly over the past 5 years.

We would in the long-term expect the Default portfolio to sacrifice around 1% return for the benefit of lower volatility compared to the average prudential balanced portfolio, thus an expected real return before management fees (typically 0.75%), of around 5% per year. Over the past 5 years this performance objective was exceeded noticeably. The default portfolio returned a cumulative 93.0% compared to 84.9% for the average prudential balanced portfolio over this 56 month period from January 2011.

Relative to the default portfolio, the performance of the prudential balanced portfolios should be more volatile due to a significantly higher equity exposure and its performance should be much closer correlated to that of the overall equity market. The default portfolio should produce a significantly more volatile performance than the money market portfolio. The table below presents one year performance statistics over the 3 years September 2012 to August 2015:

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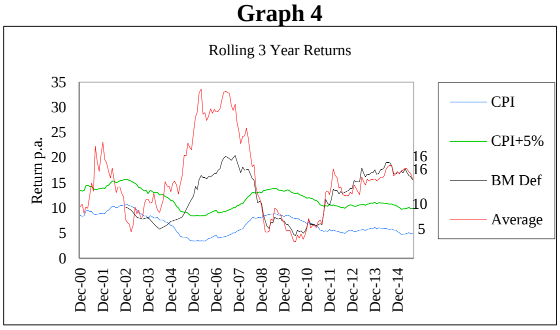
Table 4.1

Measure	Money Market	Default Portf	Average Prud Bal
Worst annual performance	5.3%	8.0%	9.7%
Best annual performance	6.6%	27.1%	25.0%
No of negative 1 year periods	n/a	0	0
Average of negative 1 year periods	n/a	n/a	n/a
Average of positive 1 year periods	5.8%	17.0%	17.2%

The Benchmark Default portfolio is a more conservative investment portfolio aimed at reducing negative returns and with a long-term return objective of inflation plus 5% before fees and roughly 4.3% after fees.

At this rate of return, the net contribution towards retirement by both, member and employer should be roughly 13% of remuneration, in order to achieve a reasonable income replacement ratio of 2% per year of service. It is very important that employers invested in the default portfolio are comfortable with these investment characteristics and that they should be able to create comfort amongst their employees as well.

Graph 4

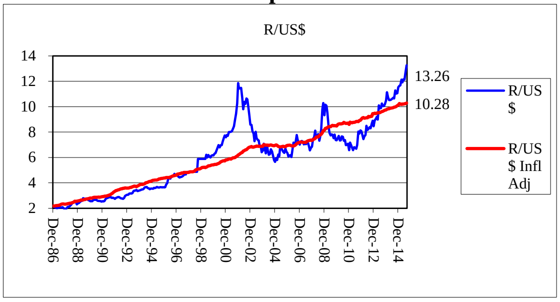


Graph 4 measures the success of the Benchmark Default portfolio in achieving its long-term gross investment return objective of inflation plus 5%, on a rolling 3 year basis. It also shows rolling 3 year returns of the average prudential balanced portfolio and rolling 3 year CPI. The Benchmark default portfolio 3 year return to end August was 15.5%, the average was 15.7% vs CPI plus 5% currently on 9.9%.

5. Review of Foreign Portfolio Flows and the Rand How is the Rand doing?

Graph 5.1 indicates that the Rand by our measure is fairly valued at 10.28 to the US Dollar while it actually stood at 13.26 at the end of August. Our measure is based on adjusting the two currencies by the respective domestic inflation rates.

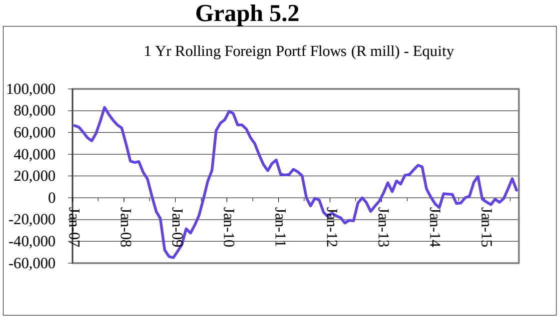
Graph 5.1



Rand continue to weakens with foreign capital outflows

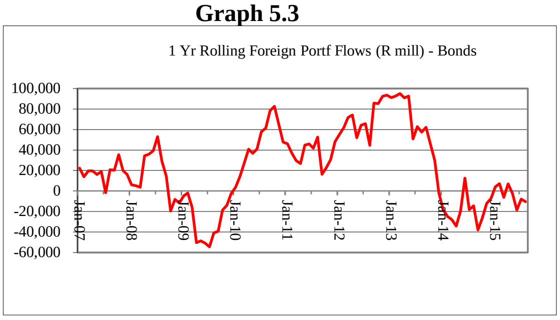
Graph 5.2 reflects a flow of capital into South African equities on a rolling one year basis, with a net inflow of 6.8 bn on a year-on-year basis at the end of August (inflow of R 17.4 bn year-on-year to end July). The month of August experienced a net outflow of R 1.5 bn. Since the beginning of 2006, foreign net investment in equities amounts to R 202 bn (end July R 204 bn). This represents roughly 1.8% of the market capitalization of the JSE.

Graph 5.2



Graph 5.3 on a rolling one year basis reflects foreign portfolio outflows in respect of SA bonds of R 10.4 bn over the past 12 months to end of August (outflow of R 7.9 bn over the 12 months to end of July). Since the beginning of 2006, foreign net investment in bonds amounts to R 216 bn (to July just over R 217 bn). The month of August experienced a net outflow of R 1.2bn.

Graph 5.3



The net outflows of foreign capital into equity and fixed interest securities was R 3.6 bn for the rolling 12 months

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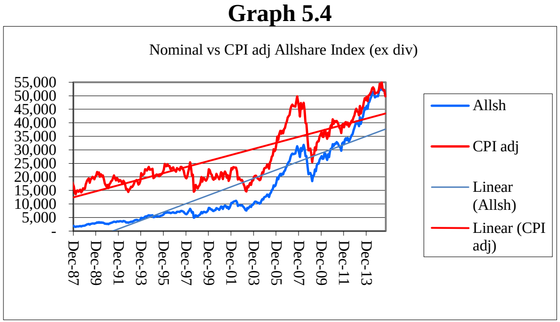
to end August 2015 (inflow of R 9.6 bn to end July 2015), compared to an outflow of R 14.4 bn for the 12 months to end August 2014 (outflow of R 23.1 bn to end of July 2014). Since the beginning of 2006, total net foreign portfolio inflows amounted to R 418 bn (July R 418 bn).

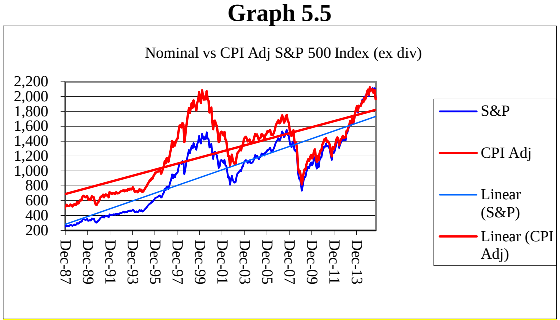
Graphs 5.4 reflects the movement of the JSE since January 1987 in nominal and in inflation adjusted terms, with trend lines for these. In nominal terms, the JSE grew by 11.9% per year since January 1987, and this excludes dividends of 3%. Namibian inflation over this period of just over 28 years was 8.4% per year. This is equivalent to a growth in real terms of 3.5% p.a. over this period, excluding dividends, or around 7% including dividends.

Graph 5.4



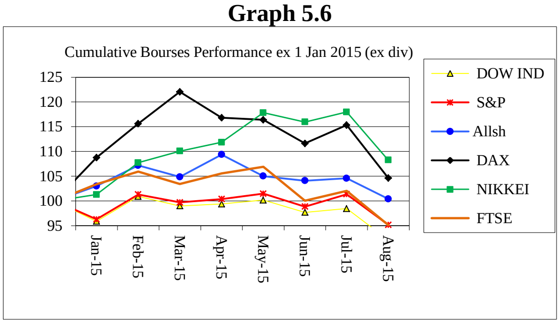
Graph 5.5 reflects the movement of the S&P500 Index since January 1987 in nominal and in inflation adjusted terms, with trend lines for these. Since January 1987 the S&P500 Index has grown by 7.1% per annum, over this period of just over 28 years. US inflation over this period was 2.7%. This is equivalent to a growth in real terms of 4.4% p.a. over this period, excluding dividends.

Graph 5.5



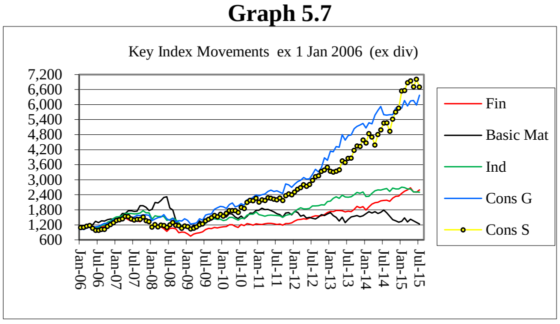
Graph 5.6 provides an interesting overview of some of the major global share indices, showing up the NIKKEI and the DAX as the top performing share indices.

Graph 5.6



Graph 5.7 provides an overview of relative movement of the key equity sectors on the FTSE/JSE since December 2005 when these indices were first introduced. From this the investor should be able to deduce which sectors offer greater value and which one's offer less value on the basis of fundamentals. Annualised returns for these indices since the beginning of 2006 were: Consumer Services: 21.4%; Consumer Goods 20.3%; Financials 10.0%; Industrials 9.9%; and Basic Materials 2.0%.

Graph 5.7



6. In times like this, stick to your investment strategy

By Tilman Friedrich

Global investment markets have disappointed investors of late. So, where are we heading and are we likely to experience more disappointment and pain going forward? The typical incriminating question then being directed at the consultant or adviser often rings – "why did you not pro-actively have us switch to a conservative portfolio"? Well, history has shown time and again, if you switch to last year's top performer every year, you will end up with under performance. Switching investment portfolios to avoid poor or even negative returns always consists of two legs – switching 'out of the market' and switching back into the market.

Very often it seems obvious that the market has overheated and that a correction is imminent, yet timing the correction to avoid getting out half way down is the first challenge that even astute investors are likely to get wrong by a far stretch like one year, two years or even longer. When the Fed instituted its monetary easing and

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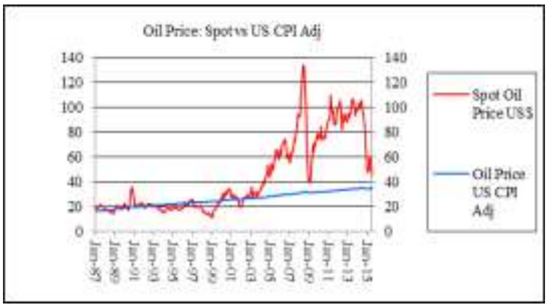
large scale asset purchasing programs, reducing nominal interest rates to close on zero and pumping up to US$ 90 billion into markets monthly to prevent the US economy from stalling as the result of the financial crisis, it was actually a ‘no-brainer’ that it will only convert a collapse of markets to a long drawn out and painful recovery. Had the investor abandoned the market at the trough and moved into cash at the time, he would have sacrificed a return on equities of 13.5% per annum to earn 6.4% per annum on his cash investment over a 7 year period, or in absolute values, his initial investment of N$ 100 in equities, that would have grown to N$ 240 by now, has now only grown to N$ 153. O.K. you may say, this is a flawed argument because one should have moved back into the market. Well, most of this recovery actually happened over the first 5 years that returned 17% per annum and would have produced an absolute value of N$ 217 by October 2013 already. Again this second leg is difficult to time, much more so than the first leg. 7 years ago you may have expected markets to go down even further yet they recovered with vengeance over the first 5 years with a very pedestrian subsequent growth of 5% per annum over the next 2 year!

So where are we heading and what should the investor do from here onwards? Let’s look at some interesting data. The following graph measures the Rand: US$ exchange rate against the FTSE/JSE Allshare Index. Evidently they are very closely correlated over this period from 1987, barring the two periods of a sudden violent swing in the exchange rate. But look at the recent past where the Allshare Index is turning down while the Rand continues to weaken – a deviation from the general trend depicted by this graph. What may be the relevance of this deviation for the investor?

Now let’s look at the next graph below. This depicts the FTSE/JSE Allshare Index against the spot WTI oil price in Rand. Once again, they are very closely correlated over this period since 1987 but look at what happened since September 2014 when the oil price took a nose dive from R 1,013 per barrel to its current level of around R 600. We were always of the opinion that the oil price was artificially inflated through speculation, mainly by hedge funds. Since hedge funds usually comprise of a spread of different commodities, global commodity prices were blown up in the same manner by this speculative thrust. Does the recent collapse imply that the thrust has now been removed altogether and that we are seeing a new normal?

Lastly, the following graph also presents quite an interesting picture. It depicts the oil price had it grown at the rate of US CPI in the blue line. Against this in the red line it depicts the spot WTI oil price in US$. There was a very close correlation over the period beginning of 1997 until end of 2003 when the spot price all of a sudden seemed to have grown wings. What it also shows, is that despite the recent nose dive of the oil price it has not yet met up with its long-term anchor, the US CPI adjusted price that is currently sitting on just below US$ 40 per barrel. You may argue that it should become ever more expensive to extract a barrel of crude in the face of diminishing resources but indications are actually that advancement in technology have largely negated the effect of the decline in resources to the point where some shale gas wells produce oil at costs that are competitive with some of the lower cost crude wells. So are we saying that the crude oil price has further downward scope?



Turning to the last question first, we believe that with the prevailing oil price, demand and supply is currently too well balanced as to provide much scope for a further sustained decline towards US$ 40 Dollar per barrel. Any decline in Chinese demand as the result of the cooling down of its economic growth will probably be made up by increased consumer demand as the result of the reduced pump prize.

If we then assume that the oil price will remain around its current levels what can we expect of the Allshare Index considering the close correlation between it and the oil price as reflected above? Without venturing into the possible reasons for this close correlation – which may be the topic of another newsletter – going by the past nearly 30 years, we would argue that there is certainly a risk that the Allshare Index may oblige and align to the oil price, which could imply it declining from its current level of R 50,000 to around R 30,000.

Finally, considering the close correlation between the Rand: US$ exchange rate and the oil price the same question arises whether the trend of close correlation evidenced over the past nearly 30 years is likely to manifest again going forward. Again going by the 30 year trend there can be an expectation that the Rand will strengthen to as little as R 8 to the US$, if the Allshare Index were to decline to R 30,000.

We believe interpolating these trends as we have done, resembles a doomsday scenario that will have widest ramifications on all asset classes, economies and personal income levels - there would be nowhere to hide. However, looking at the global economy there is no rising sun in sight anywhere really, even if one wants to believe the US economy is on the mend. Global transportation data, an important indicator of global trade currently does not point to a global recovery but rather to the opposite and much of the improvement in the US economy can probably be ascribed to the rapid expansion of the shale gas industry.

Conclusion

Given this economic backdrop, what should an investor do in times like this? First of all, a mind change is required to assure peaceful sleep and that is to focus on real returns rather than absolute returns. Attaining real returns will ensure that your wealth increases, which is most important in the face of prevailing market risks. Forget about double digit returns with an inflation rate of around 3%. Next be very clear on your investment time horizon – the longer this is the more you should invest in equity. Thirdly, experts would tell you to consider your risk appetite. Well, your risk appetite must be shaped to fit your income needs. If you cannot survive on a cash return on your investments, you have a problem and you essentially only have one choice. You need to increase your investment risk and adjust your appetite to this, and you must adapt your life style to reduce your cost of living. Pensioners should consider what dominates there expenditure patterns and match their investments with the dominating future liabilities. In other words if 20% of your costs relate to medical expenditure consider investing 20% of your capital in health care. Remember that you should try to avoid investing in any equity that lingers around its peak; rather go for those that are on the way to the bottom.

So, all this means that as an active fund member and while still some distance away from retirement you should not shun equities but should be cautious, spread your risks as far as the law allows and focus on picking the right stocks. When approaching retirement or in retirement already, determine what income levels you require and what investment returns these dictate. If cash returns would meet or exceed your needs, you can increase your investment risk to the extent that your needs can stomach volatility. Be aware that cash returns may not always deliver real returns, in which event you would have to gradually reduce your cost of living to make good for the loss of purchasing power of your capital, or you would need to increase your investment risk by adding riskier asset classes such as bonds, property and equity. Finally do not panic because of volatility but stick to your investment strategy!

7. Important notice and disclaimer