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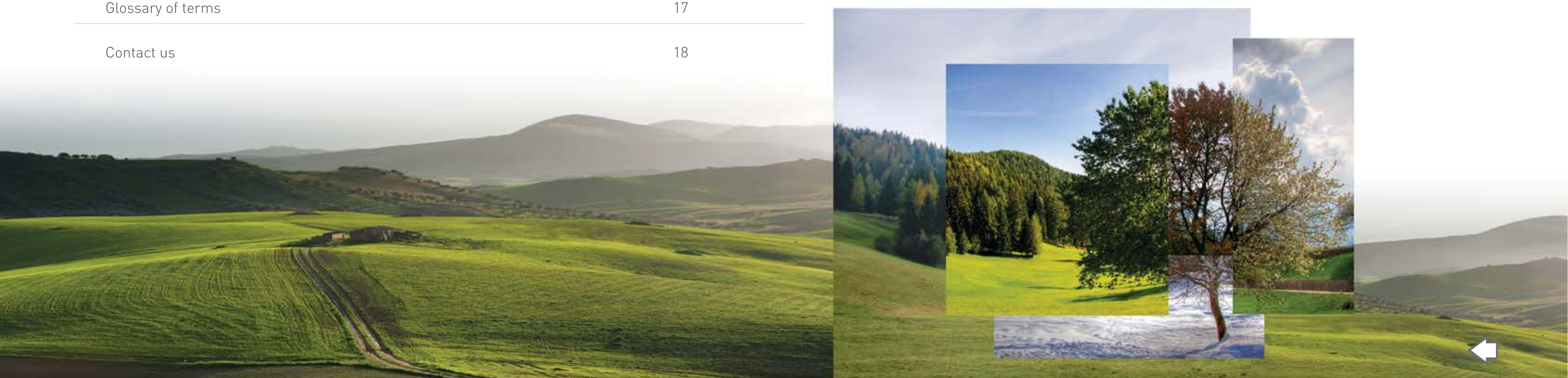
momentum asset management fixed-interest strategies | july 2014

Diversity is in our DNA

contents



foreword

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please click here to play it in your browser.

The second quarter of 2014 saw somewhat calmer global and local fixed-income markets, but this looks transitory to us as uncertainty remains high. This is a central theme of this edition of *For your Interest* and the team's thoughts around some of the realities facing fixed-income investors will hopefully convey the unprecedented investment backdrop we currently face. Volatility, by definition, is two-way and it is possible to make cohesive arguments for being drawn to fixed-income asset classes, or shunning them totally, at present.

In line with this theme, we take a look at the current reality facing US policy makers and how the contrarian outcome for the US economy would likely impact domestic fixed-income investors. If the global environment is not tough enough to fathom, domestic investment decisions are further complicated by the uncertainty of the monetary policy reaction function. In the same way that many traditional approaches to analysing markets have been rendered ineffective post the global financial crisis, so too is the potential monetary policy backdrop in South Africa. There is much debate around what the next cycle will look like given that the authorities find themselves in such a stagflationary bind. Getting the monetary policy cycle right is key to successful positioning in all other fixed-income asset classes and we have put some thoughts down on the current monetary policy reality in South Africa. Lastly, while traditional fixed income exhibits high volatility and uncertainty, we believe that there is a strong argument for well-structured credit exposure adding some diversity and defensiveness for investors. Our credit team explores this further, demystifying the asset class and highlighting some of the key realities of the local credit market outlook.

We would like to take this opportunity to thank our clients for their continued support and give our assurance that we will continue to do our utmost as custodians of your assets in a world where fixed-income investing poses unique challenges.

Conrad Wood

Head of Fixed-interest Strategies
Momentum Asset Management

What if the US Federal Reserve does not normalise policy for a long time to come (a contrarian view)?

By Conrad Wood: Head of Fixed-interest Strategies

So, here we are, six years post the global financial crisis (GFC). What is the relevance of a six-year period, you may wonder? Well, it is approximately the amount of time that Reinhart and Rogoff (leading commentators) famously suggested it would take the US to deleverage post the GFC and subsequent balance sheet recession.

There is a fairly strong consensus view among commentators and investors across the world that the US has paid its dues and set itself up for a period of economic growth and subsequent normalisation of what are unprecedented macro policies. This is generally taken to mean that the US Federal Reserve (Fed) will reduce the size of their $4 trillion balance sheet, raise the Federal Funds rate and allow the yield on US treasury bonds to fluctuate more freely (likely at much higher levels). The move higher in treasury yields is one of the most expected and anticipated consensus trades that the collective market has ever held, as evidenced by market surveys and positioning data (everyone claims to be underweight/outright short) on US treasuries. After all, surely US policy makers can't artificially hold the level of the world's most liquid and tradable asset class at significantly distorted levels for such a long period of time? Or can they?

To understand the extent of the distortion, one only needs to look at the yield earned on a 10-year US government inflation-linked bond **(see chart 1)**. Established theory will tell you that the level of real yields should approximate the level of real GDP

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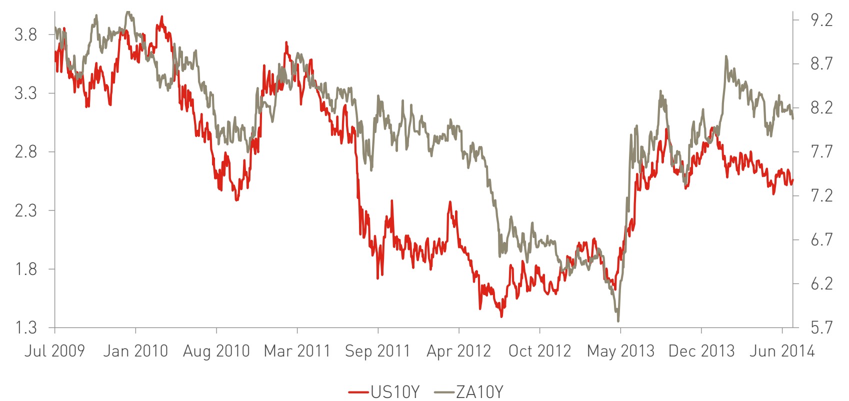
growth of the economy over time. Indeed, prior to the GFC, US real yields averaged 2.25% to 2.5%, which was roughly in line with the real performance of the economy. One can then understand yields plummeting post crisis as a recession dawned, but they haven't really risen much since (and six years down the line). Indeed, for a lengthy two-year period from mid-2011 to mid-2013, investors in US inflation-linked debt earned negative real yields, i.e. they had to pay interest to the US government in exchange for receiving inflation. Since then, yields have backed up, but are barely positive, even with headline inflation approaching 2% and the economy showing decent growth momentum post a stumble through a weather-induced slowdown in Q1 2014.

The consensus view, and indeed we would fall into the same camp, suggests that an investor in US inflation-linked bonds cannot possibly earn a marginally-above 0% real return for the next 10 years. This would cause a real distortion in savings behaviour and allocation of capital. Rates have to rise and, in the process, total returns realised by nominal and inflation-linked bond investors will be severely impaired and thus these rate-sensitive fixed-income investments need to be avoided. In addition, this normalisation of yield levels in the US will directly impact the performance of emerging fixed-income markets given the high correlation traditionally observed between the two (85% over the period illustrated in **chart 2**). In a normalising yield environment in the US, most investors expect emerging market currencies and fixed income to come under significant pressure.

Chart 1: 10-year US government inflation-linked bond yields

Source: Bloomberg

Chart 2: Normalisation of yield levels in the US will directly impact performance of emerging fixed-income markets



Source: Reuters

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What if the Fed does not normalise policy soon?

Any robust fixed-income portfolio construction process would have a set of scenario outcomes that the base case view needs to be stress tested against. Given the high consensus theme highlighted earlier, the appropriate question to ask would be: what if we are all wrong and the Fed does not normalise policy anytime soon? Surely the entire collective of the worlds' smartest fixed-income investors can't be wrong? Our view is that, when there is such a strong consensus, that's exactly when it's likely to be wrong, no matter how smart we think we all are. Could we possibly have a scenario where the Fed does not normalise policy for an extended period to come, which, by definition, means that US treasuries continue to generate strong returns and, in turn, pull emerging market fixed income along?

Of course we can! It would be unprecedented and likely have dire consequences at some stage in the future (the next recession comes to mind), but it could certainly happen. Call it American confidence or arrogance (you decide), but an ex-US policy maker had the following to say on their ability to get themselves out of their current hole (and I paraphrase): "We have taken off in a plane which we have no idea how to land, but damn have we become good at refuelling in mid-air". We are in unprecedented times and so extrapolating historical norms and policy actions into the future is meaningless. US authorities have a very asymmetric policy bias at present: avoid deflation at all costs, even if it means tolerating above-target inflation! This gives them a very dovish bent to start.

On top of this, one can very easily see a scenario where the US economy loses momentum as the quantitative easing (QE) drug wares off, the fall in unemployment proves a technical one due to structurally-declining labour force participation rates, wages remain suppressed, consumers discover they have not de-leveraged enough and the private sector indefinitely delays ramping up investment capex as they don't have look-through to a decent return on this capital. This cocktail of fundamental factors is not that farfetched and, indeed, some of them are perhaps playing out to some extent at present. Given the Fed's policy bias highlighted earlier, we believe that they would not hesitate at all to take the foot off the brake and put it back on the accelerator should the earlier scenario begin to pan out. Unless they invent some 'new policy toys', their solution would be to re-fuel the plane in mid-air, again (i.e. reinstitute QE), and take the prospect of rate hikes off the table completely.

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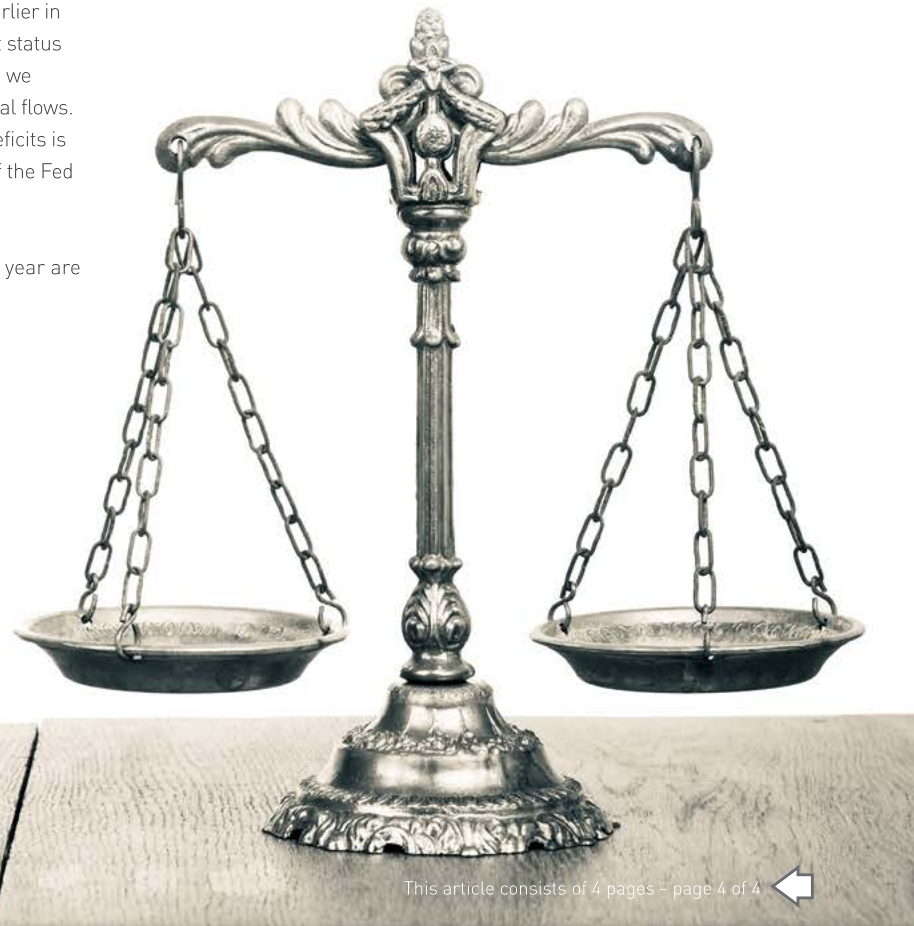
QE4?

The challenge they would face is whether the marginal impact of QE4, as it would be termed, would be as great when it comes to driving up asset prices and thus the animal spirits of the consumer. It may be much less impactful to the real economy than prior stimuli, but one thing we do know is that US treasury yields will plummet towards the lows (1.50%) previously reached. Developed market fixed-income returns would be double digit and this would almost certainly feed through to emerging market fixed income, likely through the 'search for yield' (foreign inflows) mechanism that has inflated emerging market fixed-income performance since global liquidity first flooded the markets. However, things may just be a little different this time around. With the emerging market fundamental backdrop not as strong as it was when global portfolio flows first came pouring in, QE4 in the US may just be a bridge too far in the sense that investors throw in the risk appetite towel on concerns that this approach is not working. A faltering US economy may just be the last straw for a vulnerable emerging market collective and one can foresee a spike in risk aversion and reversal of investor complacency that may drive portfolio flows, ironically, to the very source of the problem: the US dollar and treasuries. For South African fixed-income investors, a Goldilocks outcome would be most desirable, i.e. 'not too hot or too cold, but just right'. We cannot afford a dramatic capitulation back into economic slowdown in the US, nor can we handle a strong normalisation of policy, as highlighted earlier in this commentary. The best we can hope for is the current status quo of 'kicking the can down the road', during which time we (crucially) have to reduce our dependence on global capital flows. Urgent structural reform and the reduction of our twin deficits is required, otherwise, to us, it appears a classic 'damned if the Fed does, damned if it doesn't' scenario.

Maybe local cash returns of 7% expected over the next year are a port in the storm? ■



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Monetary policy:
is this time different?

By Bulent Badsha
Strategist
Momentum Asset Management

History has taught us that the past tends to repeat itself and one should be very careful when using the phrase 'this time is different'. However, the South African Reserve Bank's (SARB's) current interest rate hiking cycle appears to be very different to those implemented in the past. The circumstances that led to the 50-basis point hike in the repo rate by the Monetary Policy Committee (MPC) in January 2014 made sense in that the committee had become progressively more hawkish in its rhetoric over 2H13 and, with the rapid depreciation of the rand exchange rate in January, the inflation outlook had deteriorated significantly enough to necessitate a tightening in monetary policy. Thereafter, we had two further MPC meetings this year (in March and May); where the monetary policy stance remained unchanged, before the recent 25-basis point hike in July.

The MPC are at pains to stress that they remain in an interest rate hiking cycle and mentioned that they may not necessarily hike at every meeting (or hike by the same magnitude). It has been a case of rhetoric remaining relatively hawkish, but actions being dovish in nature. Past experience has shown us that it is most difficult for policymakers and the market at the turning points of interest rate cycles, but easier between them. This is due to the fact that it takes time to acknowledge that monetary policy is inappropriately calibrated, but, once this is accepted, the hard work is done and all that is required is remedial action. Since the adoption of the inflation targeting monetary policy framework in 2000, there have been two hiking cycles. In 2002, all four hikes were by 100 basis points, while, between June 2006 and June 2008, all 10 hikes were by 50 basis points. Strangely enough, we found

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the turning point of this cycle (the January hike) easier to justify than any subsequent decision. Very soon after the hike, the MPC launched a co-ordinated campaign to downplay the significance of the hike and calm the market's expectations over the extent of the hiking cycle. We are reminded that decisions are data dependent, but, with inflation pushing higher and growth lower, it does not make the MPC's decision any easier. The previous hiking cycle had three distinct phases, which allowed incoming data showing even further deterioration on the inflation front to necessitate further tightening. This may well become the case again, although such a lengthy pause following the initial hike is unprecedented.

Ideological differences at play

There appears to be two distinct ideological nests on the MPC: interest rate 'hawks' and 'doves'. Flying between these two nests are a few swing voters. Monetary policy in South Africa remains relatively orthodox in comparison to some offshore central banks in both the developed and emerging world. However, it is unorthodox relative to South Africa's own history. Experimental monetary policy has been all the rage since the global financial crisis, with meaningful implications for central bank independence and credibility. Central bankers, globally, have been struggling with their market communication strategy. Notable recent gaffes were from Federal Open Market Committee (FOMC) Chair, Janet Yellen, at the March FOMC Q & A and, later, from Bank of England (BOE) Governor, Mark Carney, in his June Mansion House speech. Interestingly enough, Governor Carney had a preceding reputation at the Bank of Canada for 'talking hawkish', without actually delivering hikes, in the hope that stern language would have the desired effect. Domestic macroeconomic policy post the crisis has seen monetary policy reach record lows in terms of interest rates. Fiscal policy has unwound a lot of the consolidation achieved since the advent of democracy. Unfortunately, the notable effect of these actions has been a significant weakening of the rand exchange rate and multiple sovereign ratings downgrades of the country's credit worthiness. The advent of consistent negative South African real policy rates in September 2011 coincided perfectly with the timing of the rand becoming a one-way bet weaker, a trend that only hit a stumbling block with the January rate hike.

A very flexible mandate

For us, the public letter of clarification on the SARB's mandate sent from former Finance Minister, Pravin Gordhan, to SARB Governor, Gill Marcus, on 16 February 2010 was a game changer in terms of monetary policy behaviour. The letter effectively permitted the MPC to leave its strict inflation targeting past behind it and embrace a more flexible approach to inflation targeting. Greater focus on the output gap and more tolerance of inflation outside the target band were key highlights of the letter, which has since come to be the reference point for monetary policy in South Africa post the financial crisis. The output gap is defined as the deviation between the actual level of output and an estimate for the economy's potential level of output. The SARB calculates that the country is running a negative output gap, with growth well below its estimate of potential growth of 3.5%. The problem with potential growth and the output gap exercise is that they are both not directly observable and remain in the 'eye of the beholder'. This focus is different to the past, where the realised quarterly average targeted inflation rate was the key determinant of the repo rate as real policy rates were maintained at a constant level

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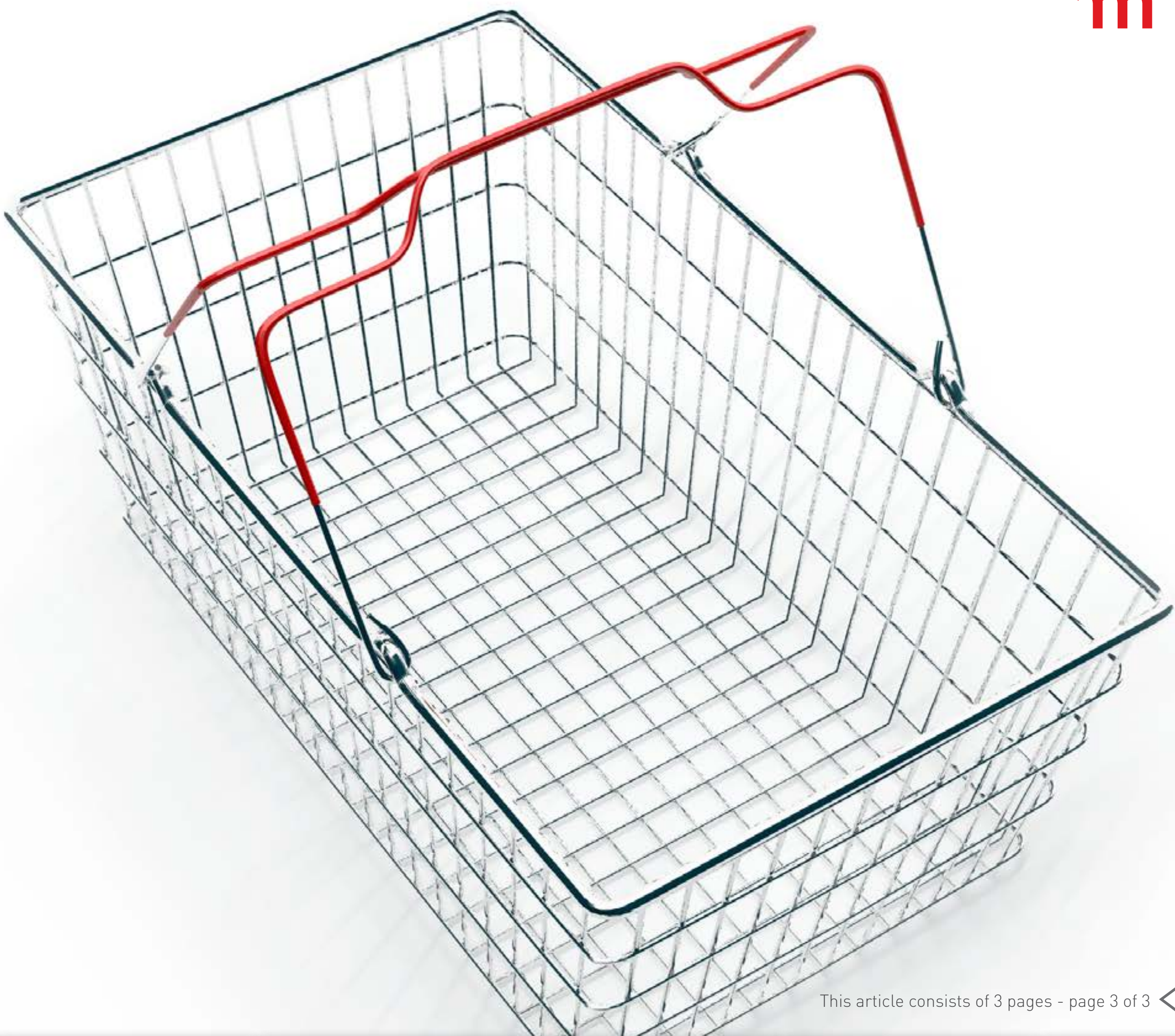
of 3.5%. It is interesting to note that, according to the SARB's very own calculations during the period 1998 to 2011, the South African economy had a zero output gap for one year, a positive one for two years and a negative one for 11 years, which included the entire period of the 2002 hiking cycle. With current negative real interest rates, savers are being punished as their savings are eroded by the ravages of inflation. Borrowers are rewarded as their debt is deflated and consumers are incentivised to spend rather than save. We see the MPC as being very concerned over the highly-leveraged South African consumer, where five years of easy monetary policy have failed to effect any meaningful reduction in household debt to disposable income.

An asymmetric reaction function

The key lesson for us in assessing monetary policy today is that monetary policy decision making appears to be asymmetric in nature, favouring easy monetary conditions. Negative real interest rates are a powerful statement, which reduces the attractiveness of cash in favour of investments further along the risk/reward spectrum. Concerns around policymakers 'falling behind the curve' in fulfilling their constitutionally-mandated duties have profound implications for the level and shape of the yield curve. We are mindful of these risks as we navigate the current uncharted economic landscape by utilising our active fixed-income management strategies. ■



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The balance between high yield and high grade, the client effect and shrinking economy

By Kefilwe Thubisi
Credit Analyst
Momentum Asset Management

By Monica Harripersad
Credit Analyst
Momentum Asset Management

Growth prospects for many high-yield issuers are inhibited in an economic slowdown as this usually translates into a weaker ability to service debt obligations and typically leads to a deterioration in credit quality.

High-yield bonds are defined as fixed-income instruments that have a credit rating which is less than BBB-. A non-investment grade rating is usually assigned for characteristics such as high leverage, unproven operating history and low confidence in management. The yield spread difference between high yield and high grade bonds fluctuates over time and normally ranges between 200 basis points and 400 basis points in South Africa. A rule of thumb is to shy away from the high-yield market when the economy is shrinking.

However, in the South African context, this is somewhat counterintuitive due to:

- Global rating methodologies penalising local issuers as a meaningful contributor to ratings is the size effect, which is captured by dollarisation of revenue.
- Levels of gearing in the issuer space being low relative to global peers, which is not rewarded in rating outcomes.
- Investors in the local credit market being predominantly local, which speaks to a closed credit economy with little room for relative play on a global platform.
- Capital losses being limited due to the buy and hold nature of the investor base.

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This means that what we consider to be high yield are essentially:

- Small-cap companies, even when some of them have a good equity performance track record.
- Unfamiliar names, even when they have demonstrated strong historical cash flow generation.
- Companies in sectors that are broadly perceived to be distressed.

The most recent default in the high-yield space was due to fraud that mystified fundamental analysis, which has caused a lot of nervousness. This was the first in South African history after the near miss of another listed corporate in 2009. Global statistics show that, overall, 2.6% of high-yield bonds went into default in 2012 (a decrease from a high 4.09% in 2009). The default probabilities typically assigned to a rating, by the rating agencies, are detailed in **table 1**.

The noticeability and expectation of defaults, however, make these statistics appear understated.

Aside from this, the small number of participants in the high-yield space could also be supported by the lack of:

- Secondary market activity leading to an inability to actively manage exposure.
- Distressed debt buyers in our market who compete for securities where they see value.

Another factor in the standoff against this 'South African high-yield credit' is the client effect. New regulations are not as restrictive as current client mandates, which dictate participation in the upper spectrum of the 'investment grade' space.

Much of the risk in these securities can be mitigated by structuring, cession of security, covenants and alignment of management interest. This should result in an increase in the level of recovery if a default materialised. Furthermore, due diligence coverage needs to be extended to include the legal enforceability of terms and conditions of the issuances. This is becoming a much greater focus as we seek to limit any potential downside in the unlikely event of a default occurring.

Some of the benefits of including high-yield bonds in portfolios are:

- Yield enhancement.
- Risk diversification.
- Positioning against inflation and a rising interest rate environment (often showing a negative correlation with bond funds).

At Momentum Asset Management, we view credit risk as an integral part of fixed-interest investing. We do not seek to avoid it at all costs, but rather evaluate, quantify and manage it effectively within the context of the yield offered. ■

Table 1: Default probabilities

Agency rating	Probability of default (mean)
AAA	0.011%
AA+	0.015%
AA	0.020%
AA-	0.030%
A+	0.045%
A	0.067%
A-	0.110%
BBB+	0.160%
BBB	0.270%
BBB-	0.450%
BB+	0.750%
BB	1.250%
BB-	2.140%

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Momentum Diversified Yield Fund

Fund information - month ended 30 June 2014

Portfolio managers

Conrad Wood
Head of Fixed-interest Strategies
Twenty years' industry experience, with twenty years at Momentum Asset Management

Richard Klotnick
Portfolio Manager
Eight years' industry experience, with five years at Momentum Asset Management

Momentum Asset Management has a strong fixed-income team consisting of 11 investment professionals, who are all dedicated fixed-income practitioners and carry no other responsibility in the organisation other than the running of the fixed-income franchise. This allows for a high degree of focus and distinct specialisation of skills within the team, which includes traditional fundamental fixed-income analysis supporting portfolio positioning, a strong capability in credit and robust portfolio construction and risk management capabilities. Our specialised credit team has strong experience in fundamental credit analysis, structured credit and securitisations. The team has developed an additional internal credit rating model to use in conjunction with evaluations from rating agencies. The team's structuring skills also allow it to self-originate favourable assets that would otherwise not be available in the institutional debt capital market.

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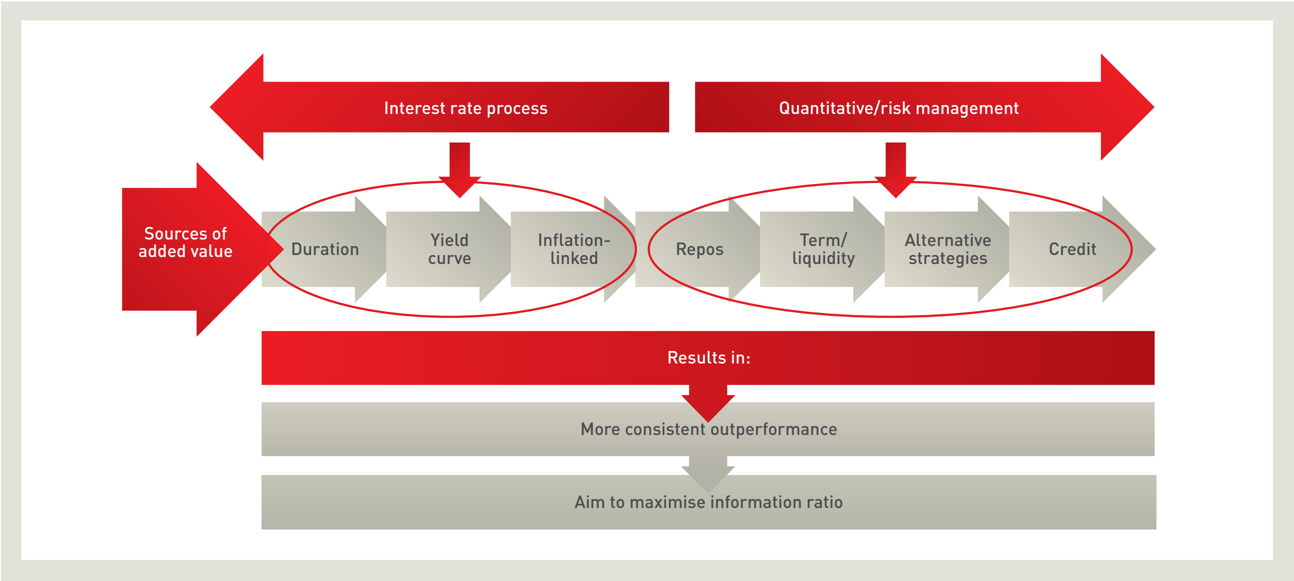
Fund objective

Momentum Asset Management's Diversified Yield Fund is a low to medium risk, actively-managed fund that tactically takes asset allocation views across a broad spectrum of fixed-income asset classes, both locally and offshore.

Investment philosophy and process

Momentum Asset Management's investment philosophy employed in managing fixed-income portfolios is based on the principle of maximising risk-adjusted returns by extracting value from as many sources as possible in an active manner. Our fixed-income investment process strives to achieve broad diversification of risk. These risks are actively managed in an attempt to generate consistent alpha for the portfolio. We strive for flexibility in terms of sourcing alternative sources of alpha given structural changes in global and local fixed-income markets.



Investment process

The ability to add value as an active manager is a function of the number (breadth) of views and the managers' skill. We take a wide breadth of decisions in the portfolio so as to eliminate the domination of any particular position on portfolio returns. Any security which has a payoff profile linked to interest rates, be it fixed or floating, with credit risk, liquidity risk or volatility risk, may be included in the portfolio, subject to the guidelines set out in the mandate. This should ensure more consistent performance by diversifying risks widely across the portfolio. The diagram to the left illustrates the building blocks and processes involved in the construction of our portfolios. Risk management is vital, with a focus on risk-adjusted returns and reducing correlations between positions. This underpins the generation of more consistent alpha.

Investment universe

The portfolio's investable universe is wide and includes a very broad spectrum of high-yielding assets, both locally and offshore. This includes bank deposits, floating rate notes, bonds, ILBs, credit-linked notes, money market conduits, asset-backed securities, commercial paper, swaps, repos, preference shares, interest rate swaps, futures, options and property.

A crucial overarching component of our asset allocation decision-making process is to marry asset class return probability ranges with the inherent risks (volatilities) of these asset classes in order to properly reflect the risk-adjusted returns of the different assets.

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Fund positioning as at 30 June 2014

Credit profile

Government	12.15%
Government guaranteed	1.48%
AAA	0.87%
AA	28.67%
A	26.38%
Property	1.63%
F1+	19.31%
F1	0.61%
F2	5.07%
BBB+	2.57%
NR	1.28%

Source: Momentum Asset Management

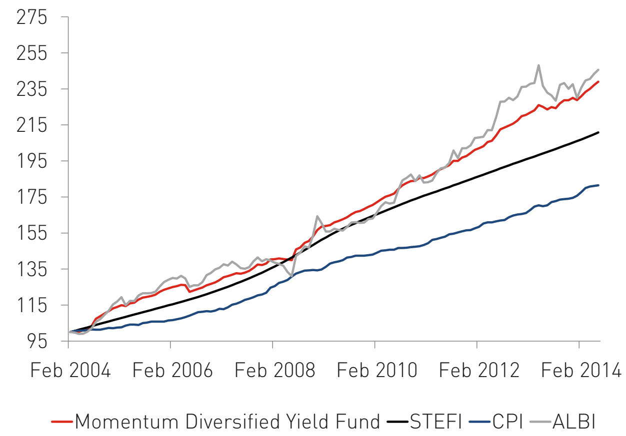
Holdings as at 30 June 2014

Instrument holdings

Bonds	52.33%
Corporate floating rate notes	11.61%
Inflation linked	8.12%
Bank floating rate notes/call	13.41%
Credit-linked notes	7.61%
Asset-backed securities	3.98%
Property	2.94%

Source: Momentum Asset Management

Fund performance as at 30 June 2014



Source: Morningstar Direct

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Why the Momentum Diversified Yield Fund?

- Suitable for investors looking for a high level of income (with moderate capital volatility).
- Diversified across fixed-income asset classes.
- Risk-cognisant performance.
- Focus on credit up to a predetermined maximum exposure limit.
- Leverages the full investment capabilities of the team.
- Mandate allows for offshore yield opportunities.
- Team-based approach to managing portfolios.
- Strong fundamental credit analysis capabilities.

Market outlook

Fixed-income assets classes have enjoyed a reprieve and recouped the underperformance relative to cash that the January emerging market selloff caused. However, the recovery has been marked by high volatility and investor complacency that appears too high to us, given all the uncertainty that exists. Bond yields look a little too low given the risk of monetary tightening in the developed world, as well as the plethora of negative domestic fundamentals that have come to the fore.

The portfolio consequently only has a modified duration of 1.10 years, which is significantly below the implied benchmark of three years. We would like to see yields some 50 basis points higher before adding meaningfully to the portfolio's duration.

The yield curve has steepened with medium-dated maturities comfortably outperforming the long-end. We are now starting to favour long-dated bonds as the yield curve is likely to flatten ahead of, and into, the monetary tightening cycle.

Credit spreads continue to be range-bound and there has not been much opportunity to add relative performance from credit spread tightening. Spreads in the micro-lending/consumer sectors remain under pressure and bank spreads have continued drifting wider, while corporate and securitisation spreads are the strong performers and continue to narrow.

Inflation-linked bonds (ILBs) continue to perform exceptionally well as policy makers tolerate higher inflation while keeping short rates anchored at low levels. Real yields have rallied since their January highs and we have been reducing exposure in the portfolio. Although listed property had a strong rebound over the last quarter, headwinds facing the sector appear challenging to us and we have used the strength in the market to lighten exposure further. The fund has around 1.0% allocated to listed property.

The portfolio has around 1% of un-hedged currency exposure as we believe the bias is for the rand to weaken further as risk premia increase in anticipation of global monetary tightening and domestic fundamentals deteriorate.

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glossary of terms

Deflation
Deflation is a decrease in the general price level of goods and services. Deflation occurs when the inflation rate falls below 0% (a negative inflation rate).

Gearing/leverage
Gearing is a general term describing a financial ratio that compares some form of owner's equity (or capital) to borrowed funds. Gearing is a measure of financial leverage, demonstrating the degree to which a firm's activities are funded by owner's funds versus creditor's funds.

High-yield bond
A high-yield bond (non-investment-grade bond, speculative-grade bond or junk bond) is a bond that is rated below investment grade.

Investment grade
A bond is considered investment grade or IG if its credit rating is BBB- or higher by Standard & Poor's or Baa3 or Moody's. Generally, they are bonds that are judged by the rating agency as likely enough to meet payment obligations that banks are allowed to invest in them.

Yield spread
In finance, the yield spread, or credit spread, is the difference between the quoted rates of return on two different investments (usually of different credit quality).

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Directors: LJ Grobbelaar SC Mabuza A Nortjé Q Richards
Company secretary: GB Drake

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