The Navigator

Strategy and Asset Allocation Report
3rd Quarter 2019

ANCHOR | NAVIGATING CHANGE

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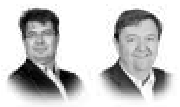
Introduction



Written By:

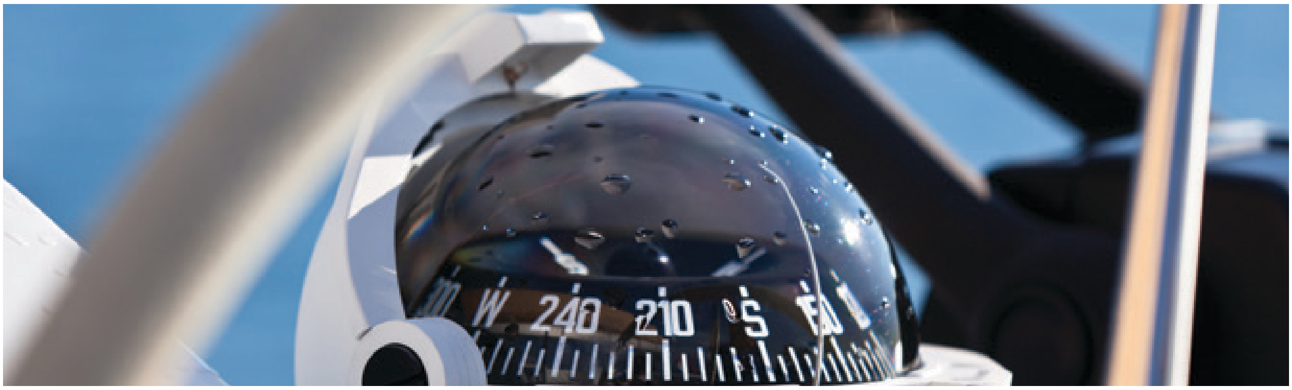
NOLAN WAPENAAR & PETER ARMITAGE
Chief Investment Officers

The second quarter of 2019 was marked by a continued slowdown in the growth rate of the global economy. However, we maintain our view that a global recession will be avoided and instead a slower new normal will establish itself. The past quarter (2Q19) was characterised by a policy shift in central banks across the globe. The US Federal Reserve (Fed) has opened the door for possible rate cuts this year, while the Reserve Bank of Australia (RBA) has enacted interest rate cuts in two sequential meetings for the first time in seven years. We expect the South African Reserve Bank (SARB) to follow suit with one or two rate cuts in 2019.

The slow growth, low rates environment will be relevant to investors for a while. We advocate a more balanced approach towards investing. Yield product in South Africa (SA) is attractive as the dependable generation of returns is appealing in an environment where equity investing is more difficult. Globally, lower yields are going to push investors into taking more risks in order to achieve their return objectives. Even in this environment, we can find companies with attractive growth prospects. Domestically, we continue to like Dis-Chem and FirstRand, whilst many of the tech companies abroad have attractive growth prospects, while trading at appealing valuations.

Coupled with the slow-growth environment, inflation is likely to decline, with SA CPI projected to be around 4.5% for the near term. We think domestic equity could return around 12.5% for the next year and, while this sounds low compared to distant history, it is a return of CPI + 8% which is actually quite compelling. On a risk adjusted basis, we find the CPI + 4% available from fixed income to be equally enticing.

We are projecting moderate returns for most asset classes and we are recommending a more balanced approach towards investing. Let your asset allocation do its job for you and be patient. Nevertheless, we do favour a slight tilt towards yield in SA and selected growth equities in the global environment.



Asset Allocation

The following table illustrates our house view on different asset classes. This view is based on our estimate of the risk and return properties of each asset class in question. As individual Anchor portfolios have specific strategies and distinct risk profiles, they may differ from the more generic house view illustrated here.

Asset Class	Current Stance			Expected Returns 12m Fwd (ZAR)
	Negative	Neutral	Positive	
LOCAL				
Equity			●	12.5%
Bonds			●	8.7%
Property		●		10.5%
Cash		●		6.7%
GLOBAL				
Equity		●		2.0%
Government Bonds	●			-5.4%
Corporate Credit	●			-4.8%
Property		●		0.2%
Cash		●		-4.7%

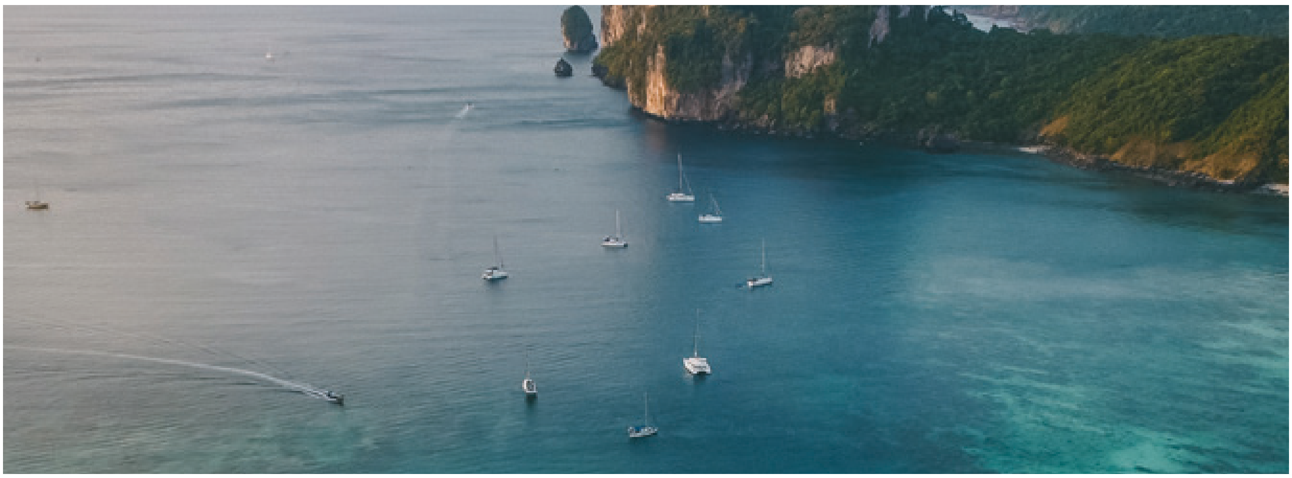
Strategy and Asset Allocation

GLOBAL BACKDROP

This past quarter (2Q19) has seen the much-anticipated SA general election come and go without too much of an impact on the market. The country remains in the throes of political instability, corrupt politicians continue in parliament rather than going to jail and a third of President Cyril Ramaphosa's first term as the head of the ANC has now passed. Eskom also continues to be the elephant in the room for any discussion around SA's economic prospects. Sluggish tax collection and vehicle sales remain symptoms of an economy that is stagnating. So, overall, it is difficult to get excited about the domestic economic outlook. Perhaps we should take some comfort from the high frequency data that is looking marginally better than in the past quarter. Signs are there for an improved local economy next year, if we can only get policy assurance and political certainty.

Globally, economic growth expectations have been trending downwards as well. The Fed's Federal Open Market Committee (FOMC) surprised at its June meeting when it opened the door for interest rate cuts. This gives some support to bonds, but slowing economic growth is nevertheless perturbing. At the same time, Brexit appears to have spiralled out of control with the UK's House of Commons seemingly out of touch with the reality in which they have placed themselves. We don't see much improvement in the situation even once the next prime minister is appointed.

Overall, the world economy has been slowing and is likely to bumble along at its current pace for the remainder of 2019.



SOUTH AFRICAN EQUITIES

The SA equity market has returned a solid 10% for the first six months of the year, although we note that the market has still not recovered from the losses incurred in 2018. We again expect a reasonable return of 10%-15% for the next 12 months through a combination of factors. Figure 1 shows the total return of the JSE Capped Swix Index:

Figure 1: JSE Capped Swix Index total return

Source: Bloomberg, Anchor

Below, we analyse the different segments of the market:

1. The "New Dawn" segment of the market (+/-50%) has performed poorly for some time now as SA GDP has stagnated and the local consumer has been under pressure from many quarters. SA is coming off a low base, which should see some improvement as the well-publicised issues of the last few years get progressively resolved. The risk is continued stagnation, although valuations are not factoring in much optimism.

2. Basic materials (15%) have been the star performers for the past two years and iron ore, which is the key driver, is trading at over $100/tonne. This is historically a very high level and, to put this in context, some Australian mines have a cost per tonne of less than $20. We expect these elevated levels to be sustained for some time but, as we move into 2020, normal cyclical forces could see the gains experienced over the past year reverse. For the time being we expect the big mining houses to continue to generate massive free cash flows and our view is that the shares should continue to do well.

3. The rand-hedge component of the market (20%) is dominated by Naspers which, in some SA indices, comprises over 20% of the market. 83% of our Naspers valuation is composed of its stake in Tencent and, we believe, that this company has great prospects for years to come. The Naspers "core" operations showed impressive growth in its recent results and the September listing of a portion of its business in Amsterdam could potentially see some unlock of the 35% discount at which the company trades to its underlying value.

4. The remaining 15% of the market has a variety of economic drivers and tends to be company specific.

SOUTH AFRICAN EQUITIES (CONTINUED)

The backdrop for emerging markets (EMs) looks fairly promising, although not without risks. Headline GDP growth is strong and lower interest rates in the US have been encouraging the carry trade. This, in turn, is positive for EM currencies, inflation and interest rates. Trump madness always poses a risk to this growth, but EMs are more domestically driven than many people assume (i.e. they have strong internal growth not reliant on exports).

Positive EMs are generally constructive for SA, as the drivers are similar, and SA usually benefits from a default flow of funds into indices. However, sentiment is currently very negative towards SA and fund managers have low weightings in SA. Many are underweight SA and far worse, many are indifferent – SA is tiny in the global context and the succession of disappointing political headlines result in potential investors turning the page. Feedback from brokers canvassing global EM asset managers is that they are happy to wait on investing in SA until it is clear that the country is on a growth path.

Many of the points above coincide with a low point in markets. Fund managers being underweight SA means there is plenty of capacity to invest once confidence is regained. Within SA, interest rates are likely to be cut, the rand has strengthened this year and, while the changes are frustratingly slow, the country is in a far better place than it was 18 months ago. Hence, optionality remains in the SA Inc. component of the local market.

The SA component of the market is cheap if reasonable GDP growth follows – banks have an appetite to lend and SA corporates will be keen to invest if they can get confidence back in the economy.

Nevertheless, risks in SA remain elevated and we are positioned in the more defensive SA-centric shares, with healthy exposure to resources and Naspers.

SOUTH AFRICAN BONDS

The SA bond market has seen quite a rally in 1H19, with the sharpest moves occurring at the end of 2Q19. The short end and the belly of the curve benefited most during this rally, with the short end strengthening by c. 73bps, while the belly firmed by 46bps and the long end of the curve strengthened by just over 24bps. The All Bond Index returned 7.6% YTD and 2.8% in 2Q19.

On the local front, we have seen an easing political atmosphere with some guidance and willingness to tackle issues that restrict economic growth in the country. On a global front, declining interest rates have reignited the search for yield. We expect that the appetite for SA bonds will remain intact in the medium term as global factors become more favourable towards emerging economies.

We believe that the low-inflation/ low-growth environment will persist in the near term with SA inflation expectations at 4.8%, while US inflation expectations are at 1.8%. For the purpose of our fundamental fair-value model, we use the long-run average inflation differential of 3.0% and the long-run average credit default swap (CDS) spread of 2.2%. Our US fair-yield estimate is 2.2%. The summation of these factors gives a fair yield for the SA R186 bond of 7.4%.

While the fair yield for SA bonds is 7.4%, political uncertainty is keeping foreigners from investing. In our view, the SARB is also resolutely keeping rates too high in order to compensate for the political risks that it is facing. This means that yields are unlikely to drift all the way down to their fair level in the near term. We are modelling on a fair yield of 8.00% for the purpose of this document. This gives us an expected return of 8.66% for the next twelve months, comprising of 8.10% interest income and 0.56% capital gains.

SOUTH AFRICAN LISTED PROPERTY

The property sector in SA remained volatile in 2Q19. However, 2019 has seen the sector's performance stabilise to some extent - this year's return is already 5.5% at the half-year mark.

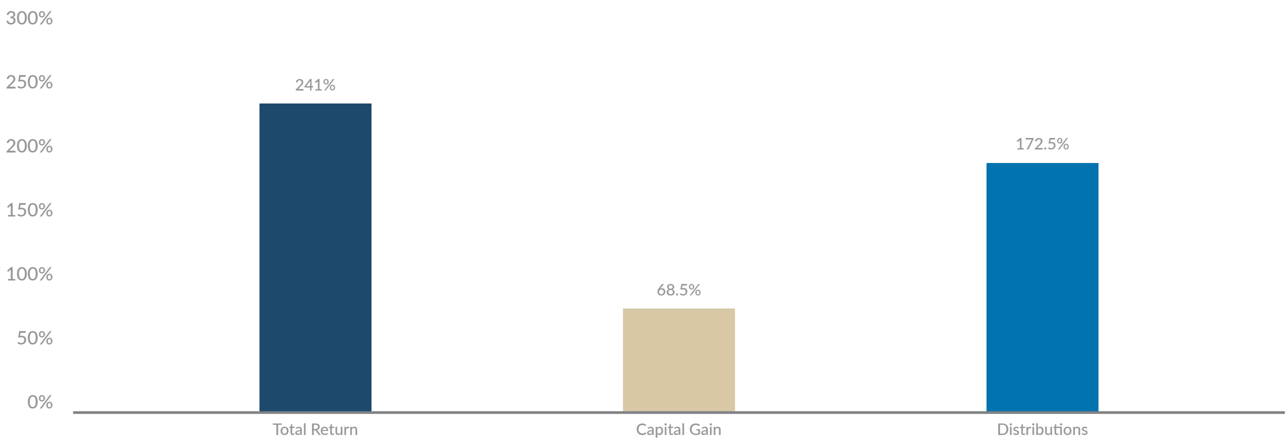
It is worth focusing on a few factors that could dictate the path of the sector's potential performance going forward. These include:

1. DIVIDEND YIELD

Despite the volatility, property is the top-performing sector in SA over a 10-year period. When we analyse what constitutes this return, distributions make up the lion's share, with capital gain only accounting for 28%, or just over one quarter, of the total return.

Figure 2: The SA Property Index 10-year aggregate return

Source: Bloomberg, Anchor



The local market has been hard hit by the economic problems that pervade SA. Added to this, valuations of offshore property companies listed on the JSE have also come under significant pressure, particularly those that own retail/shopping centre assets. In the UK, for example, falling income streams have meant that physical property valuations have come down. In addition, where companies are indebted to a higher-than-very-conservative level, they have been brutally punished as property valuations are adjusted downwards, net asset values (NAVs) fall and, in certain instances, bank covenants are breached.

Although this has not happened anywhere near the same extent in SA, there are nevertheless fears that physical property valuations are too high, and that the listed market is being "efficient" in pricing in falling net operating income and lower NAVs. This leads us to the next focus area:

SOUTH AFRICAN LISTED PROPERTY (CONTINUED)

2. PHYSICAL PROPERTY VALUATIONS

A property's value (and by extension a portfolio of properties) is estimated as the sum of the present value of a series of future cashflows generated by that property, discounted at an appropriate discount rate. This is consistent with the discounted cash flow (DCF) methodology of valuations. The discount rate is estimated based on the total rate of return expected by the market on alternative investments / asset classes with similar risk profiles. It is possible that, the total rate of return expected by the market has been distorted lower – leading to higher valuations – in the SA-listed real estate investment trust (REIT) market. The reasons for this include:

- REITs have been the marginal buyers of institutional quality income-producing properties over the past 5 years;
- but, more importantly, REITs (in general – but specifically those in the Resilient Group of companies' stable) enjoyed a cost of capital advantage to their unlisted peers due to their demanding valuations i.e. lower yields.
- However, the point made above is no longer applicable having been "priced out" given the fall in listed share prices. It is also unlikely to return in the near-to medium-term.

It is therefore likely that SA property valuers have been too optimistic in their assumptions relating to:

- rental growth; and/ or
- not appropriately incorporating the necessary capital expenditure requirements (for the property to achieve rental growth in-line with market rental growth) in their valuations; and/ or
- using discount rates that are potentially still anchored to a period where REITs were the marginal buyers and enjoyed a substantial cost of capital advantage.

Property valuations and NAVs in SA are therefore likely to follow the European trend downward. One could therefore argue that the listed equities market has behaved (somewhat) rationally in anticipation of this by pricing many listed counters at a substantial discount to their NAVs.

3. SA PROPERTY COMPANIES' NAVS

Investors in SA have historically focused more on dividend yield than NAV. As shown earlier, this is what drives the total return from the sector over time. However, the trend in Europe and the rest of the world has been to evaluate property shares on a mix of NAV (equity like value) and dividend flow (coupon/ income-derived value), with a distinct leaning towards NAV over the past 12- to 18-month period.

An analysis of where SA stacks up, does show that physical and listed valuations have de-coupled and, as presented above, physical valuations will probably come down towards listed valuations

An analysis of where SA stacks up, does show that physical and listed valuations have de-coupled and, as presented above, physical valuations will probably come down towards listed valuations. However, there does appear to be a lot of headroom to absorb this.

- 76% of the universe of 40 listed JSE property stocks trade at a discount to NAV.
- This proportion is the same for the SA Property Index ([JSAPY] where there are 21 stocks listed).
- The average discount at the index level is 14%.
- The highest premium is 12% (NEPI Rockcastle), whereas the highest discount is 60% (Accelerate Property Fund).

CONCLUSION

In order to try and predict the return range for the sector going forward, the documented issues need to be considered, and they are largely negative. Notwithstanding these, and their associated sentiment issues, we are of the view that the poor property fundamentals and "noise" is largely priced-in at these levels. We therefore maintain that this presents a safe entry point (for long-term investors) to gain/ increase exposure to the SA listed property sector. Our total return expectations for the listed property sector is c. 10.5% compounded p.a. over the long term.

THE RAND

Projecting the rand's value in a year's time is a fool's errand. The rand vs US dollar exchange rate is one of the world's most volatile currency pairs and trades well away from any modelled fair value for long periods of time. We note, however, that the rand trades within a R2.50 range to the dollar in most 12-month periods.

It is reasonable to expect that, as a more positive EM environment develops, we will see the rand move towards the mid-point of the range

We retain our purchasing power parity (PPP) based model for estimating the fair value of the rand and we have extended this out by three months since our last publication. Domestic inflation has been averaging about 4% to 4.5% of late and is likely to average about 4.8% for the next year. In response to SA's more benign inflation outlook, we have adjusted the inflation differential with the rest of the world down to 3.0%. This has lowered our forecast for the rand somewhat.

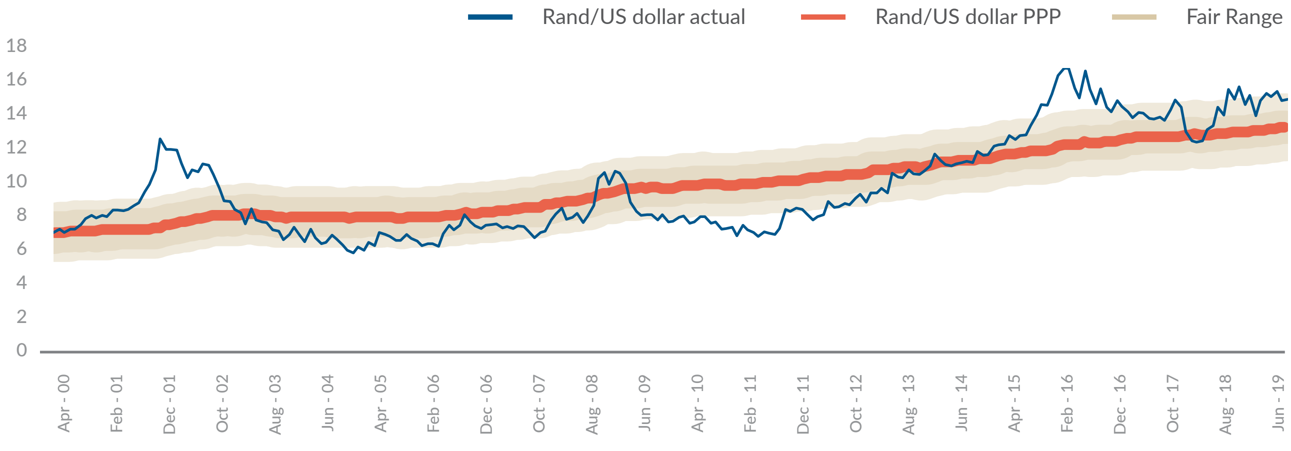
Our PPP-modelled value for the rand vs US dollar at the end of the next 12 months is R13.27/$1. We apply a R2.00 range around this to get a fair value range of R12.27-R14.27/$1.

It is reasonable to expect that, as a more positive EM environment develops (in response to lower global interest yields), we will see the rand move towards the mid-point of the range.

We note that the rand ended 2Q19 at R14.08/$1, which is within our fair-value range. Therefore, whilst we are positive on the prospects of the rand to recover a little further, the movements will remain random depending on both global and domestic events. For modelling purposes, we have used the R13.27/$1 mid-point of our range.

Figure 3: Actual rand/ US dollar exchange rate vs rand PPP model:

Source: Thomson Reuters

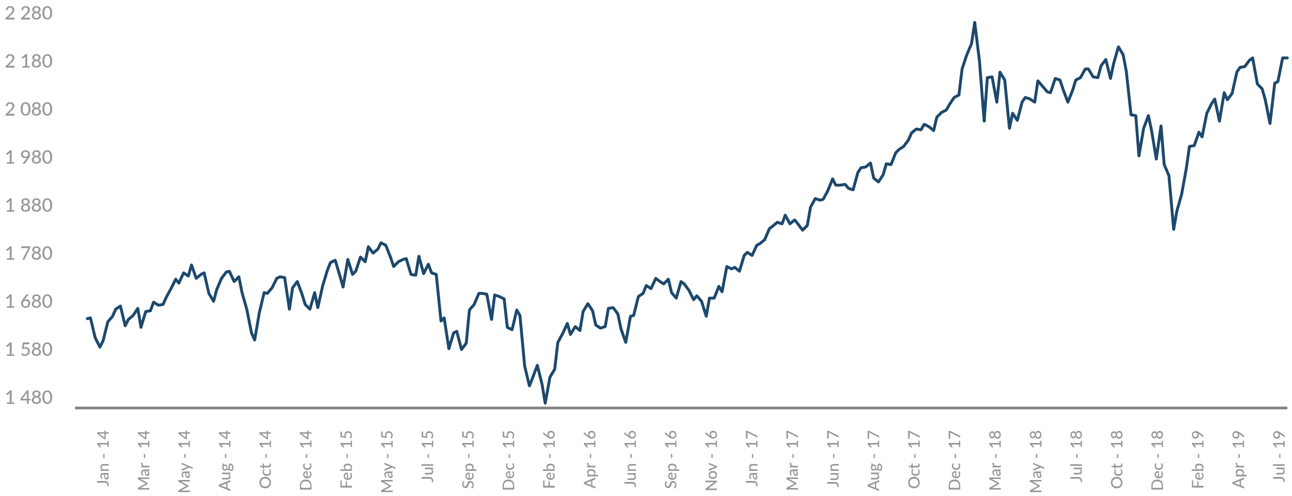


GLOBAL EQUITY MARKETS

Global trade tensions have dominated global equity markets over the past 12 months. The resultant moderating of global growth prospects has seen market volatility increase. Market levels are back to those seen at the end of September 2018, with a 15% rebound YTD. We expect an 8% return from global equity markets over the next 12 months, which is in line with historic averages. The rand return is likely to be less positive, given our view that the rand will probably strengthen over the next 12 months. Figure 4 below shows the MSCI World Index over the past five years:

Figure 4: MSCI World Index, January 2014 to date

Source: Bloomberg, Anchor



Despite the fact that this is one of the longest positive runs in global markets, dollar returns have been relatively muted and have lagged earnings growth. The MSCI World Index is up 4.2% over the past 12 months (vs the S&P 500's 8.2% rise) and the compound return over the past five years is 4.6% p.a. (vs S&P 500's 8.4% gain).

The MSCI World forward PE has oscillated either side of 16x for the past five years and is currently trading just above this level. Markets seem fairly priced assuming reasonable world economic growth. The risks to this have risen and hence our base-case return projection is moderate.

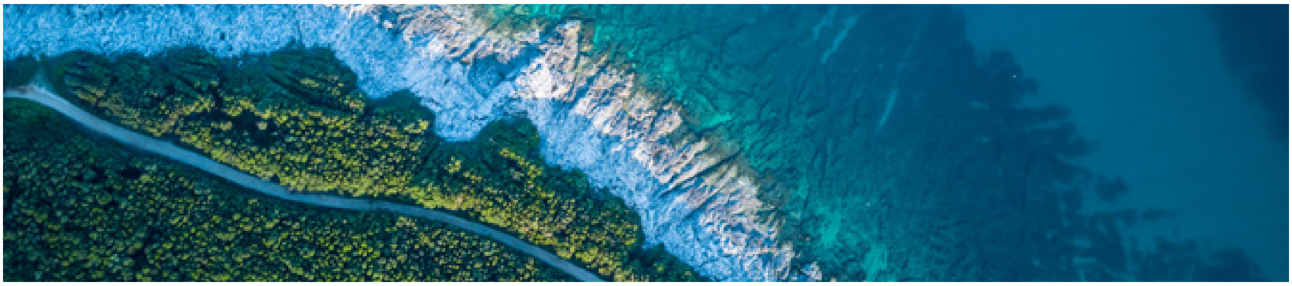
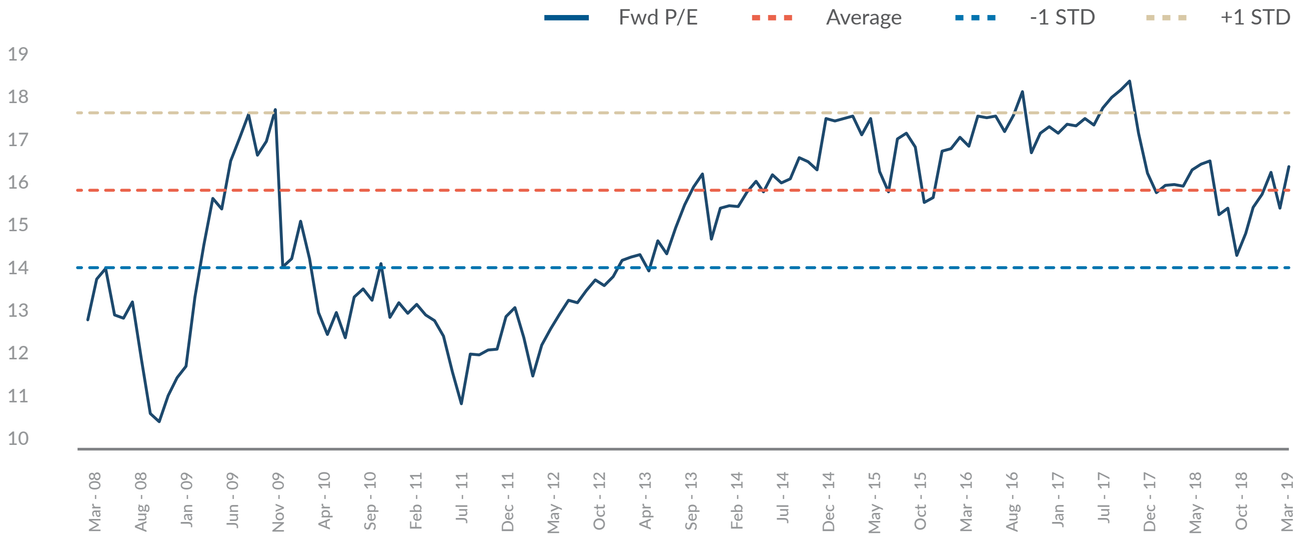


Figure 5: MSCI World fwd PE

Source: Bloomberg, Anchor



All eyes will be on earnings growth over the next 12 months. The jitters caused by trade tensions has seen confidence levels reduce and the consensus view is now for just over 3% world economic growth (from c. 4% a year ago). This downgrading of growth expectations saw markets decline in 4Q18, but most developed market (DM) central banks reacted by indicating that they are prepared to cut interest rates to stimulate growth. This has seen firmer markets this year. A positive resolution of the trade spats and a reasonable outcome could see a further bounce in markets.

The level of bullishness regarding global equity markets has retracted and individual exposure to the market is low by historic standards. However, analysts are fairly bullish about earnings (see Bloomberg consensus numbers in Figure 6 below) and if the 14% forecast earnings growth for the next 12 months for the S&P 500 Index materialises, our projected return could be exceeded. Average earnings growth over the past 10 and 20 years is in the region of 8%.

Figure 6: Global market metrics

Source: Bloomberg consensus

	Earnings Growth		FWD P/E		
Date	YR 1 (%)	YR 2 (%)	Current	YR 1	YR 2
MSCI WORLD INDEX	15.0	7.3	18.3	15.9	14.8
MSCI EM INDEX	9.1	-0.5	13.8	12.6	12.7
MSCI ALL COUNTRY WORLD INDEX (10% EM)	14.0	6.1	17.6	15.4	14.5
S&P 500 INDEX	14.1	11.7	18.6	16.3	14.6

The one-year forward PE of 16.3x for the S&P 500 (and 15.9x for the World Index) is relatively undemanding and should underpin markets, in our view. Bond yields are back at levels of around 2% and borrowing costs are likely to be subdued for an extended period, making equities relatively attractive.

We favour the US market for equity exposure. The negative impact of a stronger dollar will work its way out of the system in coming months and there is strong growth momentum from the tech giants which, on average, generated 17% turnover growth in their recent results. Traditionally defensive shares such as utilities and tobacco companies have performed well in these market conditions, but their relative lack of growth has seen them lag. Trump has also latched his success to equity markets – claiming kudos for recovering markets – and he is likely to be market-friendly moving towards the November 2020 elections.

Europe has delivered a similar return to the US this year (16% vs 17%), but a lack of earnings growth in this region will make superior returns hard to achieve. The upside surprise could be the UK, where Brexit has restrained share prices.

EMs are trading at a 20% discount to DMs, although this has been the trend for the past decade. We like the tech space in EMs, where secular trends are relatively unaffected by tariffs. There is a reasonable chance that commodity prices will rollover towards the end of the year (as the current "perfect storm" reverses) and these are especially important for this segment of the market. All eyes will be on China's ability to stimulate its economy as many metrics point downwards.

The risks in global equities have increased as global growth slows, but the actions of politicians and central bankers could spur markets further. While the economic expansion is long in the tooth (and the slow bull market continues), we would still maintain at least neutral exposure to global equities, especially given the relative unattractiveness of other asset classes.

GLOBAL BOND MARKETS

2Q19 saw another escalation in the trade war between the US and China and, this time, central bankers began to agree with interest rate markets that perhaps it was time to start thinking about pre-emptive rate cuts. US Fed Chair Jerome Powell, suggested in early June that he was "ready to act" to sustain economic growth and the members of the FOMC seemed to agree, with 7 of the 17 thinking that it would be appropriate to cut rates twice this year and only 1 member believing that a hike would be appropriate. Just three months ago, six members were keen to hike rates this year and none thought cuts were likely. Across the pond, European Central Bank (ECB) Chairman Mario Draghi, whose 8-year term at the helm ends in October, said that many of the ECB members had raised the prospect of cutting rates further into negative territory in response to protectionism. The ECB also pledged not to raise rates at least through the first half of 2020 (well after Draghi leaves).

The interest rate markets are still well ahead of the FOMC members in terms of expectations for this year, with about two and a half cuts priced into fed funds futures and the average FOMC member expecting only an 80% chance of a single cut. The fed funds futures are the basis for our front-end rate forecasts and, with 6-month rate expectations having dropped 0.6% since our previous forecast (that's the biggest quarterly change in 6-month rate expectations since the global financial crisis in 2008), its unsurprising that our 10-year yield forecast is also substantially lower. We've slightly increased the probability of the global economy deteriorating over the 12-month forecast horizon, but our base case remains that the Fed will cut rates and stabilise economic growth, normalising the yield curve. The probability weighted outcome leaves us with a US 10-year yield at 2.2% in twelve months for a total return of 0.4% in US dollar terms.

US investment-grade corporate bonds spreads are marginally tighter for the quarter, having rallied alongside risk assets in 2Q19, but we still feel that at this stage of the cycle its most likely that spreads drift wider. The combination of higher rates and wider spreads leaves us with a one-year total return expectation of about 1.0% in US dollar terms.

GLOBAL PROPERTY

2Q19 was lacklustre for global property with the FTSE/EPRA/Nareit Developed REIT Index up only 1%. In a quarter where global equities were up 4.2% and US 10-year bond yields fell 0.5%, this should have been the sweet spot for property stocks, but the global REIT index was held back by retail REITs (comfortably the largest sector at 23% of the index), which were down 5% in the quarter. The retail sector is still being held back by concerns around store closures and structural challenges as shoppers embrace online shopping. UK REITs were also 4.4% lower in the quarter as Brexit uncertainties put pressure on an already challenged sector.

Growth rates for global property income have started to slow recently and, while our expectations for global interest rates are now about 0.4% lower than they were a quarter ago and property yields have remained static in the face of falling interest rates, we see this subdued growth as a headwind to any potential re-rating. We thus expect a dividend yield of around 4.0% (growing at c. 2%) to deliver a total return of 6.0% over the next year. However, we note that this is highly contingent on how Brexit plays out (UK REITs account for c. 5% of the global index) and, more importantly, what happens in the retail property space (accounting for 23% of the index).

Expected Returns on Underlying Assets

The table below summarises our return estimates for the major asset classes.

Equity	PE1	E2 g (%)	Exit PE	Div (%)	Return (%)	ZAR (%)	ZAR Return (%)
LOCAL EQUITY	11.3	9.8	11.1	4.3	12.5	-	12.5
GLOBAL EQUITY	16.2	7.1	15.9	2.8	7.7	-5.8	2.0
Developed Markets	17.7	8.0	17.2	2.6	7.6	-5.8	1.9
Emerging Markets	12.6	5.0	12.6	3.0	8.0	-5.8	2.2

Bonds, Property & Cash	Yield (%)	Capital (%)	LC Return (%)	ZAR (%)	ZAR Return (%)
BONDS					
Local Government Bonds	8.0	0.7	8.7	-	8.7
Global Government Bonds	2.2	-1.8	0.4	-5.8	-5.4
Global Corporate Credit	2.7	-1.7	1.0	-5.8	-4.8
PROPERTY					
Local Property	9.5	1.0	10.5	-	10.5
Global Property	4.0	2.0	6.0	-5.8	0.2
CASH					
Local	6.7	0.0	6.7	-	6.7
Global	1.1	0.0	1.1	-5.8	-4.7

Note: Sector weightings are by Market Capitalisation; Global Equity benchmark is MSCI World; “PE1” is 12 month forward PE; “E2 g%” is our estimate of earnings growth over the 12 month period, commencing in 12 months time; “exit PE” is our estimate of the PE multiple in 24 months time; “Div %” is our estimate of the dividend yield over the next 12 months; “Return” is our return estimate, over the next 12 months, implied in the tables assumptions about earnings growth, dividends and changes in PE multiples; global markets are estimated in USD, local markets in ZAR; “ZAR” is the currency effect of translating into ZAR; “ZAR Return” is our estimate of ZAR market returns over the next 12 months as implied in the other columns of this table. Benchmark SA bonds are the South African 10 year government bond; The Benchmark Offshore Bonds are the US 10 Year Government Bond, and the Bloomberg Global Investment Grade Corporate Bond Index; The Local Property benchmark is the JSAPY Index; Offshore Property is the S&P Global REIT Index. “Capital “ is our estimate of the capital appreciation or depreciation of an instrument over the next 12 months; “LC Return “ is our estimate of the total return, i.e. yield + capital, that the instrument will generate over the next 12 months in its local currency; “ZAR” is our estimate of the currency effect of translating non-ZAR yields into ZAR; “ZAR return” is our estimate of the “LC Return” in ZAR.

ANCHOR INSIGHTS

In this section, staff from across Anchor provide insights into our thinking, strategy and view of the world. This quarter: Nolan Wapenaar discusses how to make fixed income work for you, with SA being less than 1% of the total investable universe globally, Darryl Hannington looks at investing in the other 99%, Liam Hechter makes the case for investing in India; and Sandy van der Zanden advises on making the choice that's right for you in terms of retirement and income.

ANCHOR INSIGHTS

Making fixed income work for you

Written by: **NOLAN WAPENAAR, CA(SA)**
Fund Management

Nolan has 20 years of fixed income experience that was gained in London, New York and South Africa. He has previously worked at Rand Merchant Bank and Deutsche Bank.

Culture in a society evolves, grows and adapts over time. Similarly, the investment culture in SA has undergone significant shifts of late. Equity returns have been pedestrian, with several significant shocks to equity markets. Investors have seen little reward for the equity risks that they have taken and fixed income assets are looking more appealing.

The SARB has doggedly fought inflation expectations down from 6% towards 4.5%, while the local economy's deteriorating fundamentals have meant that the cost of borrowing has remained stubbornly high in order to compensate investors for SA's increased risk profile. The convergence of these factors means that investors can now purchase bonds issued by any of the major banks in SA with a yield of 9%. For an investor that has walked a tiresome journey with equities, locking in a highly probable outcome of CPI+4.5% holds significant appeal. Many investors and their advisors have also developed a comfort level and familiarity with equities. Unfortunately, they are not as comfortable with fixed income and, in many cases, simply fear the unknown.

As with equities, it is possible to have high-risk fixed income strategies or very low-risk strategies.

As with equities, it is possible to have high-risk fixed income strategies or very low-risk strategies. In fixed income, these risks are not always immediately apparent. We could quite easily construct a high-risk portfolio that actually produces a stable, predictable outcome every month, until one day it doesn't. Conversely, we could construct a portfolio that is volatile on a MoM basis, but carries almost no risk over a 5- or 7-year period, making it more attractive for longer-term investment needs such as living annuities. We attempt to unpack these options here and to give our readers a sense of what to look for in distinguishing between different fixed income portfolios. We do this by comparing the Anchor BCI Flexible Income Fund with the Anchor BCI Bond Fund and by explaining what the risks associated with fixed income really are, and what purpose each of these funds serve.

In managing a fixed income portfolio, the fund manager has a limited number of levers that they can pull to achieve an investor's desired outcome. The portfolio yield, duration and credit risk exposure are important for all fixed income funds. Some portfolios might also include exposure to currency risk, listed-property risk, equity risk and derivative risk. We look at each of these options in more detail below.

PORTFOLIO YIELD

Fixed Income investments are essentially loans that pay interest to the investor with the loan being repayable at a future date. The simplest form of fixed income investment is a bank deposit with which everyone is familiar. The portfolio yield is essentially the average interest rate that investments in the portfolio are earning. This represents the yield that an investor expects to earn on their investment (before deducting the portfolio manager's fees). The yield serves two purposes, first it is the primary source of returns for the investor and second, the interest margin provides a safety cushion in terms of capital preservation. If the portfolio yield is 9% p.a., then the investor can reasonably expect to earn 9% (less management fees) on their investment every year.

If we assume that we have two portfolios, one with a yield of 7% and one with a yield of 9% then, after one year, the investor in the 9% yield portfolio would expect to have a greater return on their investment. Assume now, that both portfolios suffer an unexpected loss of 7.5%. After the first year, the investor in the 7% portfolio has earned 7% interest income and lost 7.5% through an unexpected event. Net, this investor has lost 0.5% through the investment. Conversely, the investor in the 9% yielding portfolio has earned 9% interest income and lost 7.5% through the aforementioned, unexpected, event. However, in this case, the investor has still achieved a net gain of 1.5% on the investment. Although this gain is unsatisfactory for the investor, they have nevertheless avoided losing their capital. Clearly, the higher yield has assisted the investor with capital preservation.

At Anchor, we place a significant emphasis on maintaining a high portfolio yield for our investors. The Anchor BCI Flexible Income Fund is currently being managed to a portfolio yield of between 9.00% and 9.35%, whilst the Anchor BCI Bond Fund's current portfolio yield is 9.70%.

DURATION

Most readers will be familiar with the interest rates that banks offer on deposits. Often banks advertise different interest rates, depending on how long you are prepared to leave your money at any particular bank. Generally, the rate that banks will pay you for a six-month deposit is greater than what they will pay for a one-month deposit, because the bank has greater certainty of funding with six-month deposits. One might say that, by extending the duration of your fixed deposit from 1 month to 6 months, you are able to increase your portfolio yield. Fixed Income managers do exactly the same, except they have greater flexibility in terms of choosing the maturity dates of their loans. Currently, they can invest for any time period from today through to the year 2048.

It is important to note that you lock-in the interest rate on your deposit at the outset of the investment. This means that, if interest rates go up tomorrow, you are still locked into the lower interest rate at which you placed the deposit. As a result, you might find yourself locked into a deposit yielding lower-than-prevalent market rates. However, this in turn also means that, as interest rates go up, the value of this investment will go down because investors now have higher-yielding alternatives that are more attractive than your investment.

Duration is a rough measure for how long you are locked into interest rates. The duration on a one-month fixed deposit is 1 month, whilst the duration on a six-month fixed deposit is 6 months. It is a little more complicated to compute the duration of bonds but, in essence, the longer the bond, the longer its duration.

DURATION (CONTINUED)

Fixed Income portfolios publish their durations from time to time. At the time of writing, the duration on the Anchor BCI Flexible Income Fund was 0.5 years, whilst that of the Anchor BCI Bond Fund was 7.2 years. These durations have a very handy mathematical property. If domestic interest rates suddenly increase by 1%, then we would expect the Flexible Income Fund to lose 0.5% as a consequence (duration of 0.5 years times 1% rise in rates = 0.5% loss). The Bond Fund, on the other hand, will see a loss of 7.2% in the same scenario (a duration of 7.2 years times a 1% rise in rates = 7.2% loss).

This measure of exposure is not perfectly precise but it is a very reliable rule-of-thumb to understand a portfolio's exposure to rising interest rates. Remember, the investor will earn the portfolio yield minus duration losses in this case.

Therefore, if rates rose by 1% tomorrow, then the investor would, over the course of the next year, have earned a return on the Anchor BCI Flexible Income Fund of 8.50% (9.00% portfolio yield minus the 0.5% duration loss), whilst in the Bond Fund the investor would have earned 1.5% (9.7% portfolio yield minus 7.2% duration loss). Investors in both funds would nevertheless still need to deduct the management fees, however, it is true that over a one-year period investors in these funds would not have experienced a capital loss.

Another useful property of duration is that losses from duration are earned back over the remaining life of a bond. Therefore, the Anchor BCI Flexible Income Fund might lose 0.5% on the day that the rates are hiked but would expect to earn most of this back over the next 0.5 years or six months. The Bond Fund would lose 7.2% on the day that interest rates rise but will only earn this back over a much longer timeframe. If your investment time horizon is 6 months, then you do not care about the duration in the Anchor BCI Flexible Income Fund because any losses today will be largely earned back within 6 months. Alternatively, if you are investing for a longer term, for example 8- to 10-years in your living annuity then you don't care about the duration in the Anchor BCI Bond Fund because the duration losses will be earned back before you need to access your capital. In this case, you may benefit from locking-in the higher yield available in the Bond Fund and accepting market volatility, knowing that by the time you need your capital, it will have worked itself out.

CREDIT RISK

We have seen with African Bank that when you are lending someone money, there is a risk that they will become bankrupt and unable to repay the loan. This will result in a permanent loss to your portfolio. Portfolio managers will gauge the riskiness of each business to which they lend money - clearly a loan to Eskom is far riskier than a loan to FirstRand. As a result, Eskom has to pay a significantly higher interest rate to investors than FirstRand in order to compensate those investors for assuming the greater risk of non-payment. In SA, the riskiest loans are paying c. 15% interest rates, whilst the lowest risk loans are paying about 7%. This means that it is very easy for a portfolio manager to invest in risky loans and offer an attractive portfolio yield, but with a far greater risk of capital loss. At present, most blue-chip corporates are paying interest rates of 8.25% to 9.5% in the bond markets. Thus, you should be cautious of portfolio yields above 10%, as the credit risks are not necessarily obvious.

In SA, the riskiest loans are paying c. 15% interest rates, whilst the lowest risk loans are paying about 7%.

There are two defences against lending money to someone who then becomes bankrupt. First, a portfolio manager is paid to understand to whom they are lending money. At Anchor, we have an established team of analysts who meet with management and know the companies well. These analysts are key to understanding, at the outset, what risks an investor might face. Their ongoing scrutiny is vital as they identify early warning signs allowing us to take remedial action, usually by selling the bonds of the affected company on the bond exchange.

The second defence is to diversify a portfolio in such a way that if we do find a bad apple in the basket of investments, its impact, while unpleasant, is small enough that our investors will not suffer a catastrophic loss. We have a highly developed set of portfolio construction rules and risk metrics that seek to minimise the impact of any single corporate bankruptcy.

With regards to the Anchor BCI Bond Fund and the Anchor BCI Flexible Income Fund, our first line of defence is our team of analysts that are very familiar with the companies which they cover.

Should an unexpected event occur, we know that a default at any corporate means investors might need up to 3 months of interest income to recoup their losses. While this is not ideal, it is also not catastrophic.

Unfortunately, there are only five large banks in SA, and we find it necessary to have significant exposures to ABSA, FirstRand, Investec, Nedbank or Standard Bank. All these banks are well capitalised and well run. We, like most South Africans, are comfortable placing a client's cash at any of these banks even though it means we have potentially larger credit exposure to the banking sector.

From a credit perspective, anyone with an investment horizon of one year would find it incredibly unlikely that they will suffer a capital loss in either the Anchor Flexible Income Fund or the Anchor Bond Fund.

CURRENCY RISK

Some fixed income portfolios invest in currencies other than the rand. This can be a significant source of volatility in portfolios. While a little currency exposure can bring significant diversification benefits to the portfolio, too much foreign currency exposure will detract from the portfolio yield and make returns volatile, often with periods of great performance and then times of stark underperformance.

The Anchor BCI Bond Fund has no currency exposure, whilst the Anchor BCI Flexible Income Fund unusually has between 2% and 5% exposure to the US dollar (currently 2.6%). This is designed so that even if the rand experiences runaway strength down to R10/$1, the impact on the investor will be 0.8% currently and, even in a worst-case scenario only 1.7%. Again, this will be cushioned by the portfolio yield.

LISTED PROPERTY AND EQUITY

Many of the multi-asset income portfolios include listed property and listed equity. Portfolio managers do this in order to take advantage of the diversification benefits of including multiple asset classes. This works well over time although, as we saw last year, if listed property misfires, then it acts as a drag on the portfolio. As with currency exposure, a small amount of listed property does bring useful diversification benefits. The Anchor BCI Bond Fund may not invest in listed property, whilst the Anchor BCI Flexible Income Fund currently holds 2.5% listed property exposure. Again, it is enough to bring some diversification, whilst being small enough that if the sector misfires again our investors will not be catastrophically impacted.

DERIVATIVES

There are several portfolio managers that use derivatives, including futures and options to take small speculative positions in their portfolios. The jury is out in terms of whether this creates a long-term benefit for investors. We are of the 'simpler is better' mindset and we avoid complex derivatives and intricate investment structures in the Anchor Fixed Income portfolios.

CONCLUSION

Hopefully, we have given readers a background into what the key risks are in fixed income portfolios and around how to think about these options in the context of assessing different fixed income portfolios.

We are often asked by clients what the risk is of a capital loss in either the Anchor BCI Bond Fund or the Anchor BCI Flexible Income Fund over a period of three years or longer. Having worked through the key risks in fixed income and understanding the strict portfolio construction metrics being applied, one will conclude that to suffer a capital loss over a period of three years or longer is almost impossible in either of these portfolios.

ANCHOR INSIGHTS

Invest(ing) in the other 99%

Written by: **DARRYL HANNINGTON, CFA**
Portfolio Management

Darryl has worked in the financial services industry for the past 14 years, servicing the needs of high-net-worth individuals in South Africa. He obtained a BComm Honours in Finance from Wits, and is a CFA charterholder.

Investing on the JSE has been extremely rewarding in the long run. SA was, after all, the best-performing market in the world from 1900 to the end of 2016, delivering an average annual return of inflation plus 7.2%. This according to the 2017 edition of Credit Suisse's Global Investment Returns Yearbook. The publication compared returns of various asset class over the period in 21 countries with a continuous investment history. In addition, until a few years ago, equity investors on the JSE were handsomely rewarded over a 10-year period with a compound annual return of 18%, which included the global financial crisis (GFC) market crash of 2008/09!

We often get asked by clients "... how is this possible - everything we read and see... suggests economic conditions over the past 15 years have done nothing but deteriorate in SA; just look at how the rand has depreciated?!" The answer is quite simple – due to the construct of the JSE it has been a fantastic hedge for local investors against poor economic conditions in the country. We are spoilt compared to many of our EM peers by the fact that c. 50% of earnings from companies listed locally are earned offshore. These revenue streams, and the companies that earn them, are aptly named rand hedges. It is worthwhile pointing out that not all rand hedges are made equal - many of these firms are selling their goods and services in other EMs and therefore generating revenue in those (possibly weaker) currencies. Over time, there has been a strong correlation between EM economic conditions and currency movements. Added to this, a number of these "dirty" rand hedges have debt issued in DMs, resulting in a negative mismatch in an environment where EM currencies (including the rand) are depreciating against their DM counterparts. This is clearly not positive for corporate earnings and, by extension, for share price returns. Two recent examples are British American Tobacco and AB InBev. Nevertheless, despite all of this, investing in equities on the JSE has been a great strategy over any extended time period.

However, the past five years have been a lot leaner from a return perspective and the JSE has underperformed most global markets in US dollar terms (albeit not severely over that period). JSE investors are in unchartered territory - there are very few periods in living memory when the local index has underperformed almost every other asset class. Even more concerning is that returns being generated are barely beating inflation in what has arguably been a low inflationary environment! In addition, you are receiving your pay-out in rand, which is crucial when viewed in a global investment context - the rand has depreciated by 5% p.a. over the past 10 and 15 years.

As both investors and investment managers, we are faced daily with severe equity market fatigue as we ask ourselves “why take equity market risk for the low returns being generated?” While this is an obvious question, as the custodians of our clients’ financial destinies, our responsibility is to make sure that hasty decisions, which could impede our clients from reaching their long-term financial goals are avoided at all costs. This conversation is also made far more difficult both in times of tough market conditions and in periods of equity market exuberance.

Now is not the time to raise the white flag on SA equities - our market is cheap on a relative basis, both when compared with its own history and to most other global markets. However, one could (and should) argue that our market is cheap for a reason – local economic conditions are about as bad as they have been since the GFC. Despite this, sentiment is an extremely powerful driving force both for asset prices and, more importantly, for long-term economic growth. In addition, share prices move quickly as was clearly shown in what has become known as the “Ramaphoria trade” early last year. After a somewhat surprising win for now-President Cyril Ramaphosa at the ANC Elective Conference in December 2017, market participants cheered the outcome as prospects of a new economic dawn were in sight. The result was that, over the next two months, there were certain sectors on the JSE (such as banks and retailers) that were up over 20%! Unfortunately, a shocking 1Q18 GDP print and continued deteriorating economic conditions as the year progressed all but poured cold water on the rally as most of these gains had reversed by early this year.

While investor sentiment often drives share price performance in the short term, economic growth drives corporate earnings and long-term hareholder returns.

While investor sentiment often drives share price performance in the short term, economic growth drives corporate earnings and long-term shareholder returns. For this reason, we were not anticipating Ramaphoria 2.0 after the recent election result - investors are likely to remain weary and will look for improvements in the macroeconomic backdrop. Should this start to transpire, we could well have one of those classic Aha! moments, where we realise that our market is too cheap and, as mentioned, assets are likely to reprice quickly to reflect the improved outlook, which makes trying to time it impossible.

Regardless of what the future holds for the local equity market, the JSE has always been a concentrated market and a combination of corporate failures and poor capital allocation by several of our corporate management teams has meant that the list of investable shares has shrunk even more over the last few years. SA is less than 1% of the total investable universe globally, which begs the question as to why we are willing to put so many of our eggs into such a small basket?

Home bias is not a SA phenomenon - investors worldwide feel more comfortable investing in companies they know well and, generally, these are more likely to be local. If you add the common misperception that it is difficult to get approval for transferring money out of SA, it makes the whole process of global diversification seem daunting for investors.

This is often a strong enough deterrent to prevent us from getting out of the starting block. Invariably, we are happy to settle for those rand-hedge shares the JSE has to offer. The reality though is that, provided your tax affairs are in order, it is a relatively painless process to get approval to transfer up to R11mn per adult p.a. offshore - a significant investment amount for even the wealthiest investor.

As equity investors with an unconstrained global mandate, we often ask ourselves "how many JSE-listed shares would we include in this portfolio?" Sadly, the answer right now is not many. Does this mean that we think SA companies are bad investments? Not at all, but the reality is that our choices become so much vaster the moment we embark on a global diversification strategy. We have access to the highest quality, most exciting companies listed anywhere in the world, where even the biggest investment managers (by assets under management) aren't constrained by the same liquidity issues facing investment managers here. Bizarrely, most SA investors would likely recognise more of the shares in the offshore Anchor High Street Equity Portfolio than they would in our local equity mandate. The fact that we are exposed to most of these companies in some way or form every day of our lives eases the home bias considerably.

So, why not sell up everything and invest it all overseas? There are investment professionals out there that would advise clients to do just that. Our answer lies in the fact that most us still need to eat, breathe and sleep in rand. Asset allocation is probably the most important aspect for an investor to consider when setting financial goals for their investments. Naturally, deciding which asset classes to invest in, and on what continent, is a crucial step in this consideration process. Our advice to clients is to try and ensure that they have provided for their rand expenses both before and during retirement primarily with local investments. Thereafter, if for no other reason than the sheer choice that offshore markets offer, it makes sense to invest most of your remaining assets abroad. Still, a measured approach is key to externalising funds offshore. In the fullness of time, we think you should have 60%-75% of your investable assets offshore, but here timing is very important.

The positive news for investors is that the relative attractiveness of our local asset classes, other than equities, is very good. Our bond market offers amongst the best inflation-adjusted yields in the world. This gives us a great chance of achieving the goal set out earlier - cater for rand expenses primarily with the lower-risk, higher-yielding portion of our asset allocation, while looking for long-term capital growth abroad. It goes without saying but seeking out quality investment advice in planning your investment journey is of paramount importance.

Investing is not a proposal and implementation thereof, but rather an ongoing journey. Our approach is to set a strategic asset allocation over time, but not fall into the trap of externalising money at extreme exchange rates, which is probably where we are at currently. So, a measured approach to externalising funds (and the timing of doing so) is key. We work hard to scour the globe for unique investment opportunities, and we will present these to our clients as they arise. While part of us might feel like economic traitors for suggesting what we have above, the reality is that we are proud South Africans but with a choice and, for now, we choose to live in the sun and (where appropriate) invest in the shade.

ANCHOR INSIGHTS

Invest India 2.0

Written by: LIAM HECHTER, (CA)SA, CFA
Fund Management

Liam is a co-fund manager on the Anchor BCI Equity Fund and is a co-manager on a number of Emerging Market Hedge Fund Mandates, Including the Anchor Accelerator Hedge Fund. Liam has been with the business since 2014.

Figure 1: Key demographic and labour metrics: A bull case for India

Source: IMF, Census, UN Population database, National Sample Survey Office, Labour Bureau

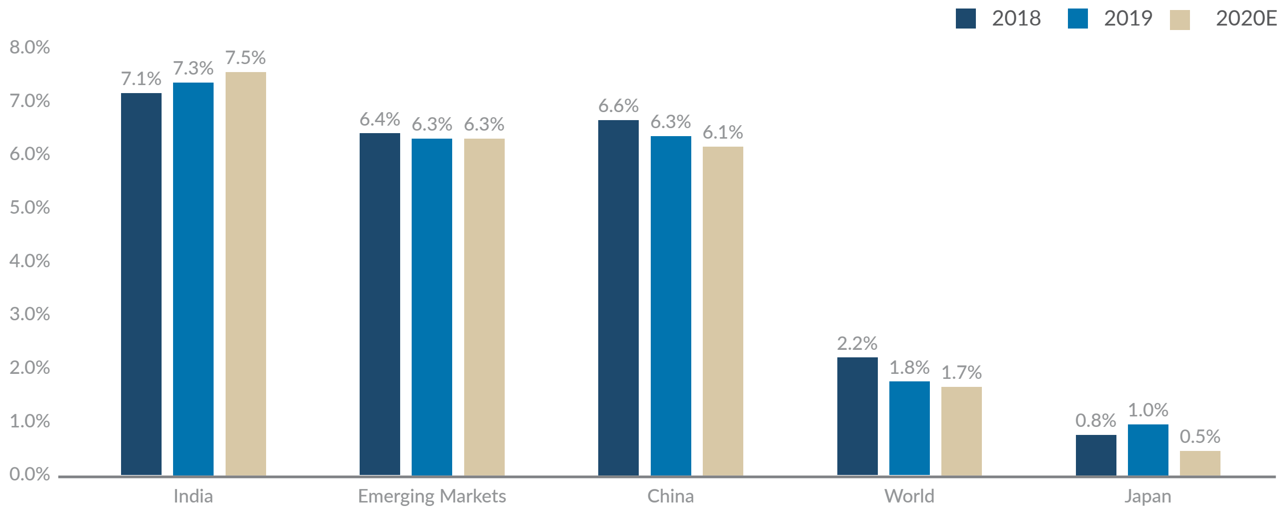
Annuity Type	1994	2000	2005	2012	2017	2023E
Population	895	1 002	1 109	1 211	1 316	1 424
15+ population	62.9%	65.0%	67.0%	69.7%	72.1%	74.4%
Working-age population	58.8%	60.5%	62.1%	64.3%	66.0%	67.2%
New working-age population			15.0%	15.0%	14.0%	13.0%
Labour force participation rate (age 15-plus)	57.8%	56.8%	57.8%	51.6%	50.3%	na
Worker to population ratio (age 15-plus)	56.8%	55.6%	56.0%	50.3%	47.8%	44.5%
Unemployment rate	1.8%	2.1%	3.1%	2.6%	5.0%	na
Workforce (mn)	328.4	354.6	394.6	419.3	430.6	453.8
Job creation - new workers p.a. (mn)		4.4	8	3.5	2.1	3.9
Job creation growth p.a.		1.3%	2.2%	0.9%	0.5%	0.9%
Nominal GDP growth		14.6%	9.9%	15.2%	11.7%	11.5%
Real GDP growth		6.8%	5.6%	8.2%	7.2%	7.7%
Personal disposable income growth		14.6%	9.1%	15.7%	11.4%	10.8%

Following a lengthy elections process of deciding the next prime minister of India, Narendra Modi (leader of the Bharatiya Janata Party [BJP]) was reelected as head of state for a second term in May 2019. Modi, perceived by many as a reformist, market-friendly leader, first came into power in 2014, with the promise of structural reforms underpinning a strong focus of freeing up economic bottlenecks and the liberalisation of the Indian economy. Over the past 5 years Modi's "new-India" has already become the world's fastest-growing large economy. However, we believe the dividends of the improved investment climate in India is only in its infancy, with many more years of above-trend economic growth ahead. At Anchor, we are constructive on the Indian investment case and we have exposure to the Indian growth story across various mandates in our business.

As a country of c. 1.3bn people, India is by far the most populous democracy in the world. The sheer size of the country, with varying cultures and religions, has made the process of governing India highly complex with various forms of economic policy dictating the country's direction post-colonial rule (India gained independence in 1947). Socialism dominated in the mid-1960s to early 1980s, which was then followed by a period of deregulation and ultimately, from the early 1990s, the economy embarked on various forms of liberalisation, the most transformative of which was the first term of the Modi government, which delivered GDP per capita growth of c. 7% p.a.

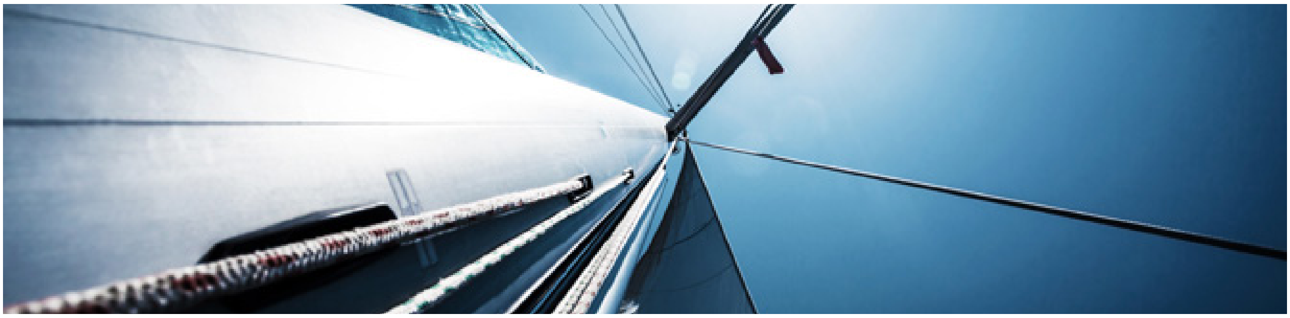
Figure 2: GDP growth, 2018-2020

Source: IMF WEO April 2019, Anchor



Few countries have the demographic attributes for economic success as strong as India, with increased optimism around the country's untapped growth potential premised on the back of the so-called "demographic dividend". According to data from the World Bank, over the coming decade India's workforce is set to surpass that of China and, for the first time in a generation, the Chinese will be dethroned as the largest labour pool in the world. It is estimated that over the next 5 years, 13mn new job seekers will enter India's working-age population p.a. and, with a labour force participation rate of c. 54%, the number of new job seekers will increase by approximately 7mn people - an increase of c. 1.5% p.a. In context, in absolute terms, the addition to India's labour force over the next 5 years will be greater than the rest of the Asia Pacific region, the US and the EU combined!

This supplementation to the global workforce differentiates the Indian investment case relative to its EM peers. However, the growing working-age population is only a boost to growth if the number of people entering the workforce is growing faster than the overall population (as dependency ratios decline), the persons actually find work and the long-term savings rate continuously ticks higher (leading to increased investment rates). The biggest challenge for Indian policy makers is creating the required investment climate that would encourage the necessary investment in ultimately putting the millions of new job seekers to work productively. Creating productive jobs is a far more difficult task today than it was a few decades ago when China went through its greatest economic transformation. An abundance of cheap labour was the foundation of China's manufacturing boom and, all things being equal, India is in quite a similar position to that of China 20 years ago (in terms of its access to labour and low levels of debt to GDP). However, as the global shift towards automation is inherently less labour-intensive, India will have to be very innovative in its pursuit of productive job creation.



The composition of the labour market and how productive each new job is towards economic growth is symptomatic of many developing countries. C. 45% of the current c. 450mn jobs in India are in agriculture, with a very low contribution towards economic growth as agriculture has the lowest productivity rate of any form of employment.

India's economic growth has long been dominated by domestic consumption and, for sceptics, the key concern is India's recent history of job creation, with only 2mn jobs created p.a. over the past 5 years. With 22mn people living below the poverty line and over half the working population employed in jobs with very low productivity, and a further 14mn new job seekers entering the labour market every year, India's structural reforms will need to be targeted at stimulating the manufacturing and export economy to avoid the potential demographic tailwind from becoming a crippling burden on the state. However, stimulating the manufacturing sector relies heavily on access to capital and promoting investment. With a large percentage of lending still being controlled by state-owned banks, the market has in recent years been dominated by poor credit controls and high levels of non-performing loans (NPLs). This has resulted in reduced access to funds desperately needed to boost the manufacturing sector. A recapitalisation of state-owned banks is a step in the right direction, however, privatisation of those institutions is ultimately what's needed in order to ensure capital is deployed in the most efficient manner.

If India's competitive advantage over the next ten years relies on an inexpensive and young labour force, then recent developments between the US and China could ultimately turn out to favour India.

While the world continues to shift away from labour-intensive manufacturing hubs, India's population demographics dictate that policy makers ultimately have no choice but for India to become a global leader in low-cost manufacturing if it wants to avoid high levels of unemployment and achieve economic growth at the targeted 8% p.a. This comes at a time where the Chinese labour force is shrinking, the structure of that economy is shifting from one dominated by investment to one dominated by consumption. Add to that the post WWII low in the relationship between China and its biggest trading partner (the US), and India's stars could potentially be fortuitously aligning.

If India's competitive advantage over the next ten years relies on an inexpensive and young labour force, then recent developments between the US and China could ultimately turn out to favour India. However, India will need to tread carefully in its dealings with a volatile US President, Donald Trump. As it stands, India currently has a modest $24bn trade deficit with the US (China by comparison has a $420bn deficit), which it will look to grow over time. However, Trump's recent decision to strip India of its preferential access to the US market (the day after Modi's inauguration) is a definite step in the wrong direction. India's loss of privilege, which was instituted by the US in order to aid the economies of less developed countries, will impact c. $6bn worth of goods previously imported to the US duty-free. While the quantum is not material in the context of India's c. $83bn worth of exports to the US – the move is more indicative of the Trump regime's hardening stance towards, and obsession with, trade deficits. Given India's need to build out its export capacity, it appears to us as though India simply cannot afford strained relations with the US.

Figure 3: India vs China economic indicators comparison

Source: Bloomberg, IMF, Census, UN Population Labour Bureau

Annuity Type	India	China
Population	1.33bn	1.38bn
GDP	$2.6tr	$12.2tr
GDP growth rate	7.20%	6.60%
GDP per capita	$2036	$9608
Labour force	430mn	776mn
Participation rate	53%	74%
Dependency ratio	51%	24%
Exports	$294bn	$2.2trn
Current account balance	-2.40%	0.40%
10-year govt bond yield	6.90%	3.20%
Inflation	8.30%	2.70%

In Modi, India has a leader who seems unafraid to make bold decisions. BJP's 2014 election manifesto made sweeping statements about tackling corruption and simplifying the tax system. This was followed up with the controversial process of demonetising high-denomination bank notes, resulting in an estimated 1%–1.5% knock to the country's GDP in 2018. At the time, these measures seemed like an extremely risky way of tackling corruption, however, one year later the number of taxpayers have risen by 25%. Another controversial move was to broaden the tax net through the introduction of a Goods and Services Tax (GST), which replaced several state and federal taxes, with the aim of taxing consumption and simplifying the collection process.

This time around the decisions may need to be even bolder. Sweeping labour (removing friction in the labour market) and financial market reforms are just a start. A multi-year, $1.4trn, fiscal stimulus package was announced in the lead-up to the election, and with government debt to GDP at 70%, the capacity to inject capital into the economy is available. However, it would need to be allocated very efficiently in order to sustainably boost economic growth.

India is positioned as an outlier from a demographics point of view.

Some of the more immediate reforms will likely include increasing flexibility in the labour market.

In previous published research on India, we highlighted the deteriorating demographics of many global economies. Shrinking workforces and high levels of debt to GDP are, under conventional economic theory, not inputs to sustainable economic growth (the so-called "Japanisation" of the world). India is positioned as an outlier from a demographics point of view; however, Indian policy makers will need to be bold in the pursuit of lifting millions of its people out of poverty and fulfilling its economic potential.

At Anchor our primary exposure is to India's financial sector, via our investment in ICICI Bank with our expectation that ICICI (and privately-owned Indian banks in general) will be a pivotal capital provider for the expected uptick in investment spending and at the front line of much-needed economic reform.

ANCHOR INSIGHTS

Retirement and income:

Making the choice that's right for you

Written by: SANDY VAN DER ZANDEN, CFP®
Wealth Management

Sandy has spent the past 12 years in financial services, addressing the key investment requirements for private clients. He has attained both his BSc Engineering and CFP qualifications.

Investor confusion is an increasing phenomenon nowadays, arising as a natural response to the ever-growing volume of data and information with which investors are bombarded daily. Currently, a stream of podcasts, news articles and opinion pieces constantly compete for our attention. The result is confusion, uncertainty and investor fatigue. For retirees, this barrage can be downright frightening.

In a world where investors are increasingly seeking guarantees, retirees are no different, but do guaranteed annuities really provide the right retirement solution for you?

RETIREMENT 101 – CASHFLOW SCENARIOS

When preparing for retirement it is essential to understand your financial needs in retirement in order to be able to address the key question affecting all retirees currently - *how long will my retirement capital last (and is that going to be long enough)?*

A cashflow scenario is a tool designed to answer this exact question. The cashflow is essentially a table showing starting capital, income drawdown and return assumptions on your capital. What it shows is how many years your money will last into retirement (and at what age you will run out of money). It is the cornerstone of sound retirement planning.

Assume you will live longer into retirement than your parents and grandparents etc.

Increased longevity is a very real phenomenon in our modern world and your retirement plan should reflect this (the longer you live, the more retirement capital you will need).

Remember to examine the key assumptions used in your retirement cashflow scenarios as these determine the accuracy of the plan (and therefore the relevance to your specific situation and circumstances). These assumptions typically include retirement age, starting capital, income required, annual income increases, and investment returns achieved. Ideally, this should reflect a conservative view of your financial situation in retirement. Also, try to build some leeway in your retirement budget to cater for the unexpected and, if possible, have some cash on hand to fund these eventualities.

Once you have a firm grasp on your income needs it is time to make an annuity selection. This is where the "compulsory" money will be invested and includes money from retirement annuities (RAs), pension funds, provident funds and preservation funds.

The current annuity options at retirement include:

- Living annuity (LA);
- Guaranteed annuity; and
- Enhanced/ with-profit annuity.

LIVING ANNUITIES

A LA is effectively a basket of assets from which an income is withdrawn. The income is limited by legislation to a range of 2.5%-17.5% p.a., which can be changed on an annual basis. Returns are not guaranteed and depend on the underlying investment portfolio returns.

LAs must be constantly reviewed to make sure that a sustainable level of income is chosen (to avoid depleting the retirement assets). If properly managed, LAs offer retirees a way of drawing a flexible income during their lifetime, and then leaving the remaining assets to their nominated beneficiaries on death.

The advantages of an LA include:

- Income flexibility.
- Beneficiaries receive the remaining asset value on death.
- Assets within a LA grow tax-free.
- LAs can be converted to a fixed annuity at any point during retirement.

The disadvantages are:

- Income is not guaranteed.
- There is a risk of depleting assets and experiencing a reducing income in later retirement years.

GUARANTEED ANNUITIES

Guaranteed annuities are designed to take the worry out of retirement by providing guaranteed income (and guaranteed annual income increases) for life. The rates offered are based on age, gender and prevailing interest rates. Annuity rates change every week and will increase the older you get. Both spouses can be covered, providing income security as a couple for life.

The advantages are:

- Income is guaranteed for life.
- Annual increases are guaranteed for life.

The disadvantages include:

- There is corporate risk (the insurer has guaranteed the income and must be around to pay it).
- Capital is forfeited on death of the last life assured (after any guarantee term has expired).
- Inflation risk - there is normally a maximum cap on the annual inflation increases so high SA inflation will erode the real value of income over time.
- Once money is invested within a guaranteed annuity it can't be moved to a LA at a later stage.

ENHANCED/ WITH-PROFIT ANNUITIES

With-profit annuities are guaranteed annuities with a twist - the starting income is guaranteed, but the annual increases in income are linked to an underlying investment portfolio. Once the increase is declared for the year, it becomes the new minimum guaranteed income going forward.

A key feature of a with-profit annuity is the guarantee that the annuity income will never reduce for any reason.

In simple terms, the guaranteed income ratchets up with the declared increases every year. If the investment portfolio returns are good, then the increases in income are good (and can exceed inflation). If returns are poor, then the annual increases are poor (and there can even be a zero annual increase declared). A key feature of a with-profit annuity is the guarantee that the annuity income will never reduce for any reason. Only the annual increases are affected by markets. The rates offered in with-profit annuities are higher than standard guaranteed annuities, which should be factored into the retirement decision. Table 1 shows indicative rates of various guaranteed annuities. The rates will vary by insurer and with the options chosen.

Figure 1: Indicative rates of various guaranteed annuities

Source: Just SA

**indicative rates for a 65-year-old male, June 2019 *Allan Gray Balanced Fund used as underlying portfolio to drive annual increases.*

Annuity Type	Anuity rate	Starting gross monthly pension	Ave. increase over past 5 years	Ave. increase over past 10 years
Level annuity	11.9%	R9,917	0.0%	0.0%
5% fixed escalation annuity	8.2%	R6,833	5.0%	5.0%
10% Fixed escalation annuity	4.9%	R4,083	10.0%	10.0%
Inflation-linked annuity	7.3%	R6,083	5.3%	5.4%
With-profit annuity	8.8%	R7,333	6.4%*	7.3%*

Some insurers also offer enhancement to the basic with-profit annuity by allowing clients to undergo medical underwriting to potentially increase the starting-income amount. This is done by assessing the annuitant's health risks and existing medical conditions such as smoking, diabetes, heart conditions etc. These factors reduce statistical life expectancy (i.e. retirees won't live as long) and, since the insurer expects to pay the annuity for a shorter period, they are able to offer a higher starting income.

The advantages of enhanced/ with-profit annuities include:

- The initial income is guaranteed.
- Annual increases can exceed inflation and, once declared, becomes the new minimum income going forward.
- Medical underwriting can include negative health factors to increase the annuity income offered.

Disadvantages are:

- Annual increases are not guaranteed (and can be zero in extended poor market conditions).
- Capital is forfeited on death of the last life assured (or after the guarantee term has expired).

WHAT IF MY RETIREMENT CAPITAL DOESN'T PRODUCE ENOUGH INCOME?

Consider reviewing the guarantee terms and increase options selected on guaranteed annuities (as these affect the income offered). It is also advisable to source multiple quotes as each insurer offers a different annuity rate.

The next step would be to revise the retirement budget and cut down on expenses (this is not a fun exercise). Remember to apply for state benefits on offer.

Do you qualify for the government's old age grant to supplement your income? You can access information on the grant on the SA Social Security Agency (SASSA) website.

IN SUMMARY

Seeking competent advice is highly recommended in this area, as the choice of annuity will have a lasting impact on your retirement finances. There are a plethora of options within each annuity, and the retirement capital can even be split between a guaranteed annuity and a LA, in order to provide a guaranteed income underpin, and investment/ income flexibility.

Assess the options within each annuity and tailor the income to your specific needs and circumstances. Finally, remember to revisit the retirement cashflows with your financial advisor regularly to make sure that your retirement remains on track.

Performance Summary

	FUND PERFORMANCE							BENCHMARK PERFORMANCE					
	Start date	Annualised p.a. (%)	Since inception (%)	12-month (%)	6-month (%)	3-month (%)	June 2019 (%)	Since inception (%)	12-month (%)	6-month (%)	3-month (%)	June 2019 (%)	Performance vs Benchmark (%)
UNIT TRUSTS													
Anchor BCI Equity Fund	Apr-13	11.6	97.9	1.6	9.0	2.1	2.4	64.3	1.1	6.9	2.9	2.9	33.6
Anchor BCI Flexible Income Fund	Jun-15	8.0	36.8	9.8	5.4	2.5	0.9	34.9	7.6	3.7	1.8	0.6	1.9
Anchor BCI Managed Fund	Jan-15	4.3	20.3	3.4	9.2	2.5	1.7	21.5	3.2	6.9	1.1	1.8	-1.2
Anchor BCI Worldwide Flexible Fund	May-13	11.2	92.3	6.4	15.0	1.6	0.7	71.1	8.5	4.1	2.7	0.6	21.2
Anchor BCI Property Fund	Nov-15	-1.7	-6.1	-2.5	1.6	1.6	0.7	-4.4	0.8	6.0	4.5	2.2	-1.6
Anchor BCI Global Equity Feeder Fund	Nov-15	6.9	27.8	1.7	18.4	2.0	1.7	39.9	8.4	14.0	1.4	2.9	-12.1
Anchor BCI Bond Fund	Feb-16	10.9	42.2	11.2	7.7	3.7	1.9	41.0	11.5	7.7	3.7	2.3	1.3
Anchor BCI Diversified Stable Fund	Feb-16	6.8	25.1	6.7	5.5	1.6	0.8	21.2	5.5	5.8	1.7	1.2	3.9
Anchor BCI Diversified Moderate Fund	Feb-16	5.5	20.2	5.2	5.9	1.5	1.1	18.5	4.4	6.8	1.5	1.6	1.7
Anchor BCI Diversified Growth Fund	Feb-16	4.3	15.5	2.8	6.0	1.1	1.2	17.6	3.2	6.9	1.1	1.8	-2.1
Anchor BCI Africa Flexible Income Fund	Mar-16	7.3	26.3	14.8	10.1	3.5	1.4	35.0	9.3	4.5	2.3	0.7	-8.6
EQUITY NOTES & SEGREGATED MANDATES													
Anchor Equity	Jul-13	8.8	65.8	3.8	6.1	1.4	0.7	63.1	1.1	6.9	2.9	2.9	2.6
Growing Yield*	Jun-12	10.4	99.5	6.3	4.2	4.0	1.1	99.0	9.5	4.6	2.9	0.7	0.5
HEDGE FUNDS													
Long Short Equity	Mar-13	7.1	53.9	1.9	4.7	1.2	0.0	63.1	8.8	4.3	2.2	0.7	-9.1
Property Long Short	Jan-14	8.3	54.8	-0.2	1.0	2.3	0.0	61.2	9.6	4.6	2.3	0.7	-6.4
Anchor Accelerator	Feb-16	7.3	26.5	19.4	14.8	-1.5	0.0	18.3	1.1	6.9	2.9	2.9	8.2
OFFSHORE													
High Street Equity - Dollars	Jun-12	12.5	127.9	12.6	22.3	6.8	6.5	110.6	6.9	17.4	4.2	6.6	17.3
High Street Equity - Rands	Jun-12	21.5	291.5	15.8	19.8	4.4	3.2	262.9	9.7	15.1	1.9	3.0	28.6
Offshore Balanced - Dollars	Jun-12	10.6	101.9	10.3	16.5	5.3	5.0	61.2	6.5	12.5	3.8	4.8	40.7
Offshore Balanced - Rands	Jun-12	19.5	247.5	13.4	14.2	2.9	1.8	179.5	9.9	11.0	2.0	1.9	68.0
Global Dividend - Dollars	Jan-14	8.5	55.2	7.8	13.5	5.4	5.0	56.6	6.9	17.4	4.2	6.6	-1.4
Global Dividend - Rands	Jan-14	13.3	96.9	10.8	11.3	3.0	1.7	98.6	9.7	15.1	1.9	3.0	-1.7
Anchor Sanlam Global Stable Fund - Dollars	May-15	0.8	3.2	3.8	7.1	1.6	1.4	11.6	2.8	1.4	0.7	0.2	-8.4
Anchor Sanlam Global Stable Fund - Rands	May-15	4.7	20.5	7.1	5.6	0.0	-1.5	29.6	5.5	-0.5	-2.2	-3.2	-9.1
Anchor Sanlam Global Equity Fund - Dollars	May-15	7.3	33.3	0.4	22.0	4.5	6.9	29.9	5.7	16.2	3.6	6.5	3.4
Anchor Sanlam Global Equity Fund - Rands	May-15	9.6	45.8	-3.0	19.7	2.3	3.2	44.2	3.7	14.0	1.4	2.9	1.6

Source: Morningstar and Bloomberg 30 June 2019

*Provisional performance returns

DISCLAIMER

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