An Overview on Asset Allocation for Balanced SA Pension Funds in 2014.

Brian Kantor; Chief Strategist, Investec Wealth and Investment;

January 22nd 2014

Risk On (overweight equities) was well rewarded in 2013- thanks to developed equity markets

Taking on equity risk was well rewarded in 2013. It was especially so for shareholders in companies listed on the developed market exchanges led by the New York benchmark, the S&P 500, that returned an extraordinary near 30% annual return. Shareholders in the average Emerging Market (EM) company did not do nearly as well, having seen the USD value of their shares decline. However when measured in depreciated local currencies, strongly positive returns may have been earned on equities, as were provided for the rand investor on the JSE. Furthermore for local EM currency investors equities are likely to have performed much better than local currency bonds or cash as was decidedly the case for rand investors. Even long dated US Treasury Bonds did not provide positive returns in rands given rising long term rates in the US. (See Figure 1 below)

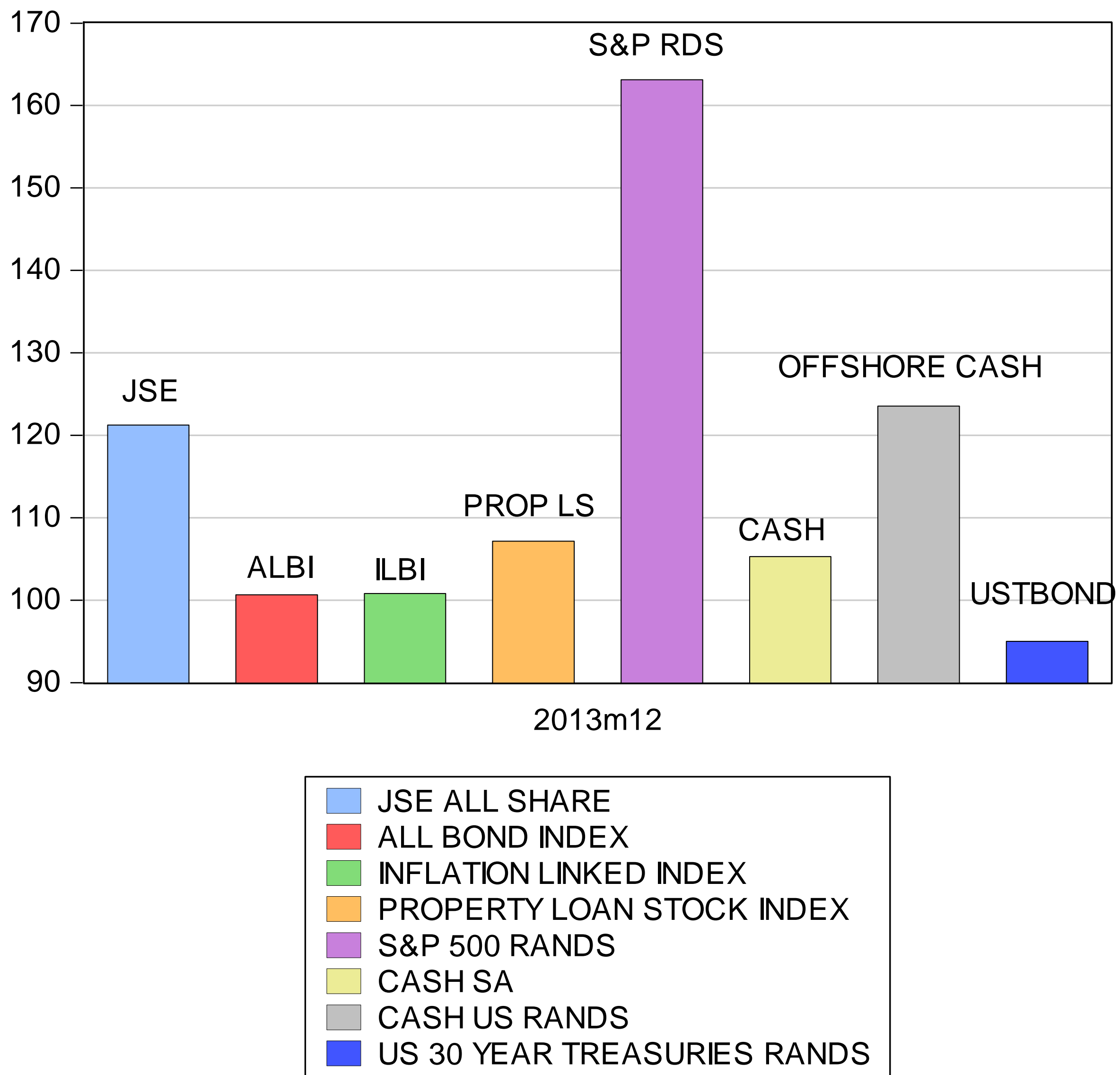
The JSE All Share Index (ALSI) measured in USD performed in line with the EM benchmark, the MSCI EM, as it usually does, having lost about 4% of its January 1st US dollar value, by the end of the year. Returns in the depreciated ZAR in 2013 were a well above average 20% compared to the over 60% rand returns provided by the S&P 500 Index.

Yet some important stocks listed on the JSE performed very much in line with the S&P 500. Not coincidentally, those industrial stocks with a global rather than a SA business footprint, performed very much in line with global peers listed on the major stock exchanges . The JSE Industrial Index, that combines essentially SA economy plays with their larger cap global players, gained about 40% in rands in 2013, a SA ownership weighted (Swix) mix of the global plays returned close to 50% in rands.

We have combined eight large JSE listed global industrial companies into a Swix (SA ownership weighted) Industrial Hedge index. Their share price gains in rands in 2013 are shown below in Figures 2 and 3. These gains were led by Naspers (NPN) of whom more than 100% of its NAV is accounted for by a Chinese internet company, Tencent, in which it holds a 35% stake. We describe this group of companies as Industrial Hedges, because their performance is largely independent of economic developments in SA, that can be favourable or unfavourable to most

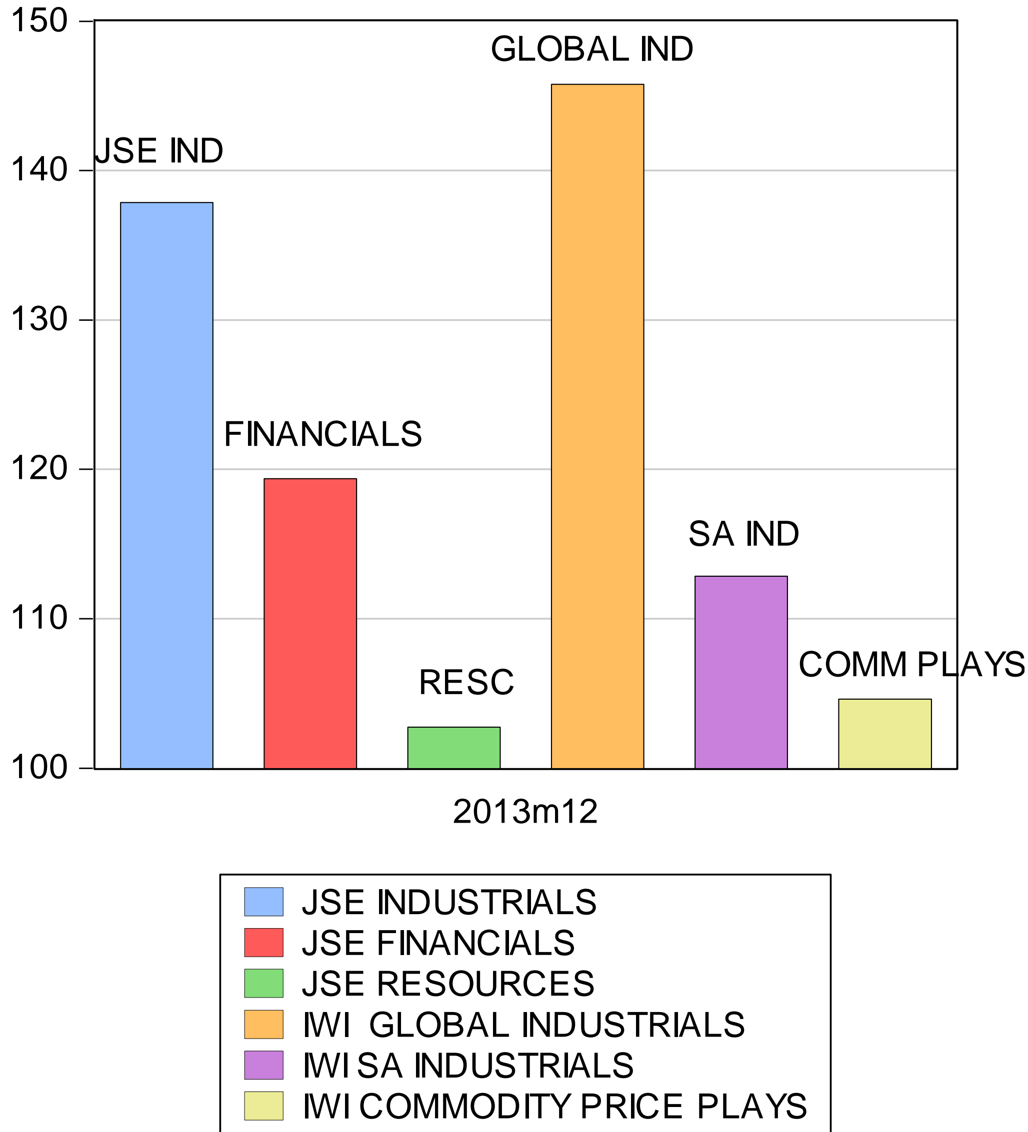
other Industrial companies listed on the JSE. For a comparison of sector returns see Figure 2 below

Fig 1; Rand returns in 2013 by Asset Class



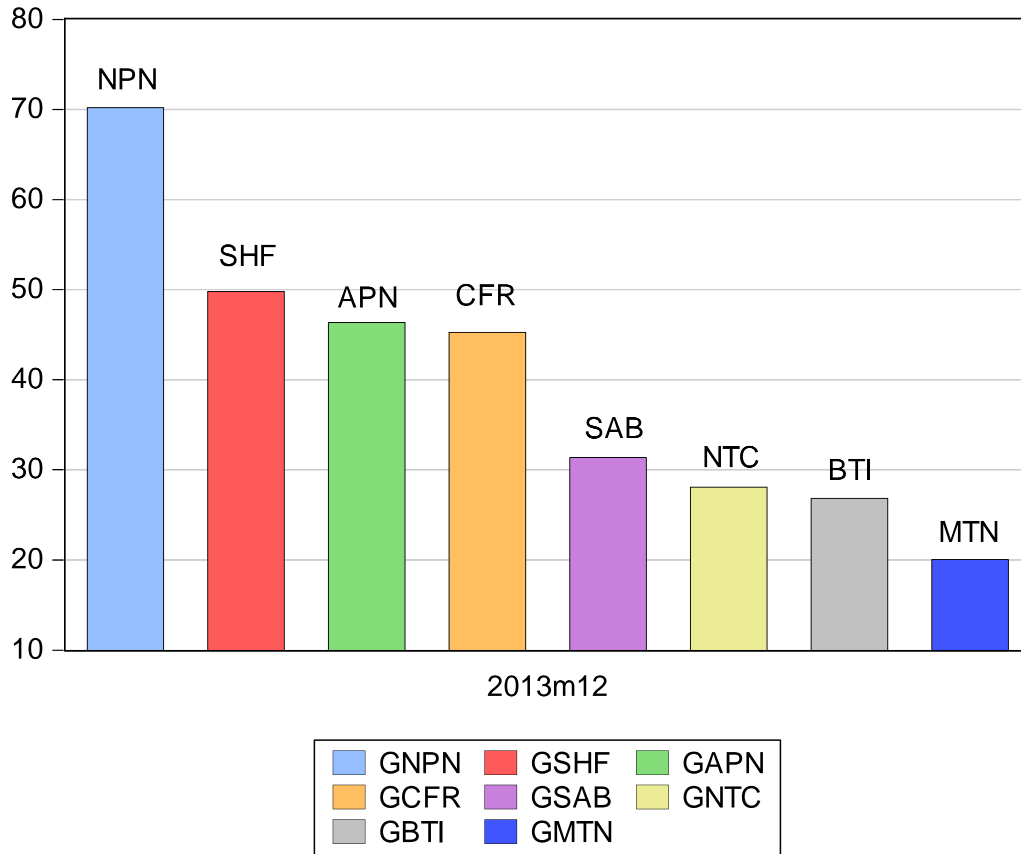
Source; I-net Bridge, Investec Wealth and Investment

Fig 2; JSE; SECTOR PERFORMANCE Total returns in 2013



Source; I-net Bridge, Investec Wealth and Investment

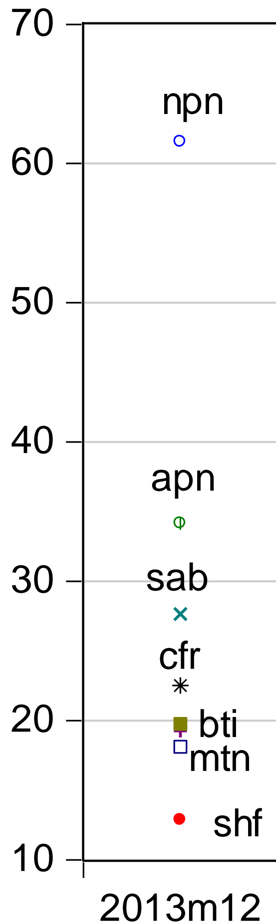
Fig 3; Selected Share Price Moves 2013 Global Plays



Source; I-net Bridge, Investec Wealth and Investment.

(G represents the compound change in 2013 of the share price of Naspers (NPN) Steinhoff (SHF) Aspen(APN) Richemont(CFR) SAB Netcare(NTC) British American Tobacco (BTI) and MTN.

Fig 4; Trailing Price earnings ratios – ranking order December 2013



○	1/NPNEY/.01	●	1/SHFEY/.01
φ	1/APNEY/.01	✳	1/CFREY/.01
×	1/SABEY/.01	+	1/NTCEY/.01
■	1/BTIEY/.01	□	1/MTNEY/.01

Source; I-net Bridge, Investec Wealth and Investment. (P/E ratios are the reciprocal of the respective earnings yields E/P as indicated above)

Why the rand matters for sectoral performance

For the JSE Industrial companies with a largely SA business a strong or weak rand can have a significant influence on valuations as inflation and interest rates follow a stronger rand or weaker rand. SA Industrials are very much rand plays whose valuations consistently benefit from rand strength and are harmed by rand weakness.

The global plays by contrast are not only hedged against SA risks that drive the rand weaker or stronger, their share prices have proved lately to have taken their cue from developed rather than EM equity markets. This may be inferred from their much better performance in 2013 compared to the average EM equity.

The key question to be asked of these stocks in 2014 as it will be asked of their global industrial peers is, how much more can be expected by way of returns from these global industrial companies in USD, including those quoted on the JSE, that proved so exceptionally good in 2013? They are after all as has been illustrated demandingly valued in the form of their price/earnings ratios that were mostly elevated through the course of 2013. This rerating- in the form of a rising P/E multiple was most conspicuous in the case of the Industrial Index leader NPN that saw its P/E multiple rise from a heady 42 times in January to over 60 times by year end.

We would suggest that what goes for the S&P 500 in 2014 will largely determine the valuations in USD attached to the JSE Industrial Hedges, as they did in 2013. For reasons to be provided below we havean optimistic view of S&P returns in 2014 and therefore would expect something like the same rate of return from the Industrial Hedges, in USD, which will translate more or less automatically into higher or lower rand returns depending on the USD/ZAR rate of exchange.

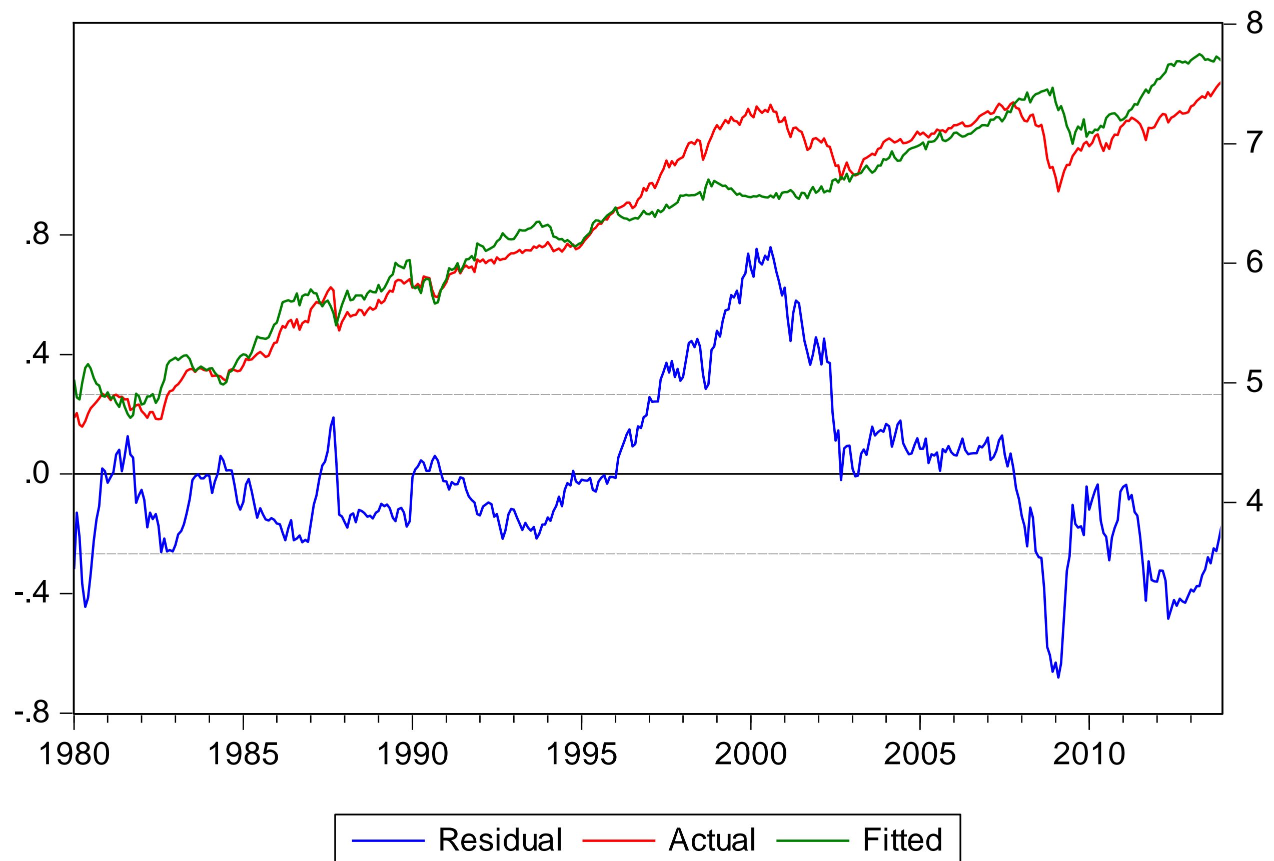
Explaining the strength of the S&P 500 in 2013- earnings growth and a lower risk premium are the explanations

The strong performance of the S&P in 2013 can be attributed in part to an improving economic environment reflected in record high operating margins and satisfactory growth in free cash flow and earnings per share and significant increases in cash released to shareholders as dividends and more so share buy backs. The outlook for growth in S&P 500 in sales revenues and sustained profit margins and so good growth in earnings and dividends remains encouraging at about the 10% per cent per annum rate. The sales and earnings outlook for Europe, where operating profit margins are far from record levels, is as satisfactory an earnings outlook as it is for the S&P 500, while the earnings growth outlook for EM equity markets of about 8% growth lags behind the estimates of earnings per share growth in the developed world.

Our sense is that the S&P 500 valuations in 2013 benefitted from a better economic performance by the corporate sector, from low interest rates that made cash and especially longer dated fixed interest securities less attractive and especially from a sense that the long term outlook for the global economy had improved. Less risk and so an implicitly lower risk adjusted discount rate came to be attached to cash flow, earnings and dividends expected from

the leading companies. Our valuation exercise for the S&P 500, that adds the level of long term interest rates to trailing earnings or better dividends as an explanation of the level of the market, suggests that the S&P remains undervalued by the standards of the past. See below. We therefore expect returns from the S&P 500 to exceed the rate of growth of earnings, expected to be about 10% in 2014.

Fig 5 The log of the S&P 500 explained by the log dividends per Index share and long term interest rates Price to dividends adjusted for interest rates – the Fed model



Source; I-net Bridge, Investec Wealth and Investment

Another way of making the same observation is that there would appear room for a further reduction in the equity risk premium in the months and year ahead. The risk premium is revealed by the degree of under or overvaluation, identified in the figure above as the residual of the model- that part of the value of the S&P 500 at end December 2013, in log terms, not

explained by the log of trailing dividends and long term interest rates. At end December the S&P 500 was 16% below its value as predicted by the Fed model.

The degree of undervaluation narrowed in 2013 according to this analysis from 44% undervalued at year end 2012 . Or in other words the risk premium decreased significantly through the course of 2013. A further reduction in the equity risk premium could add value to S&P listed companies even should interest rates in the US rise further, as they are expected to do, as revealed by the current modestly upward slope of the US government bond yield curve.

Expected long term interest rates in the US

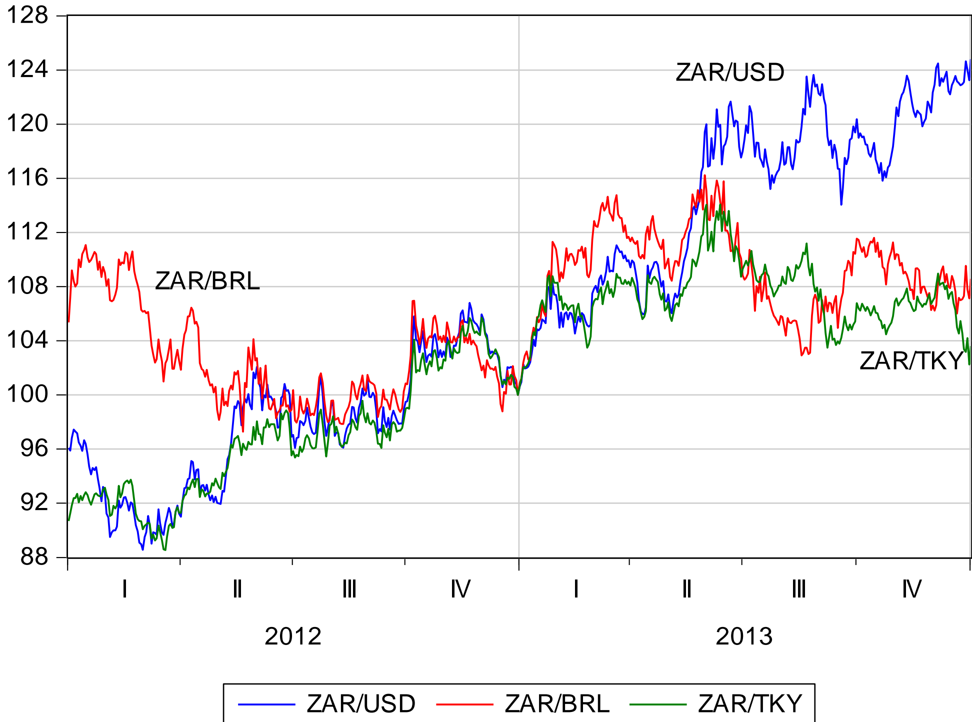
The US Treasury Bond Yield curve implies that the 10 year bond yield currently around 2.82% p.a will gradually rise to about 4% p.a after five years and is predicted to remain at this level for a further five years. The 10 year inflation linked US Treasury Bond, currently offering a real yield of 0.5% p.a. is expected to rise to 1.54% in five years. These higher rates if they materialised as currently expected would represent a return to something like normal interest rates for low risk securities.

The JSE appears overvalued when the same valuation analysis is applied to the JSE.

Similar valuation exercises undertaken for the JSE reveal a degree of over rather than undervaluation of the market for trailing earnings and current interest rates. The reason for this is the currently depressed level of JSE All share index earnings, especially when converted to USD at current depreciated exchange rates. Earnings of JSE listed Resource companies are well down, some 38% lower than earnigs per share realised a year before, The poor performance of the Resource companies h dragged down ALSI earnings per share (down 6.4%) despite the strong earnings outcomes for Industrial Companies listed on the JSE (up 15.1%)

The problem for Resource companies listed on the JSE and elsewhere in Emerging Equity Markets is that USD prices for metals and minerals have declined. The much weaker exchange rates will have helped to protect Resource companies and their earnings against lower dollar prices. Generating revenues in USD, while costs are incurred in the local currency that may well increase at a much slower rate than prices, when expressed in the local currency, should mean an improved operating profit margin in both the local currency and in USD. But this protection to the bottom line, will only materialise if mining production is sustained and rand costs of production are contained. This was not the case for the SA mines disrupted by strike action and violent protests that first raised their ugly head at the Marikana platinum mine in August 2012. These events added to SA specific risks and weakened the rand relatively to other emerging market currencies as well as the US Dollar until approximately mid-2013 when the rand tended to move in line with other weaker Emerging and Commodity currencies, even strengthening against some since mid 2013, as we show below.

Fig 6; The rand Vs the USD and some EM currencies



Source; I-net Bridge, Investec Wealth and Investment

JSE Resources are priced for a strong recovery in earnings

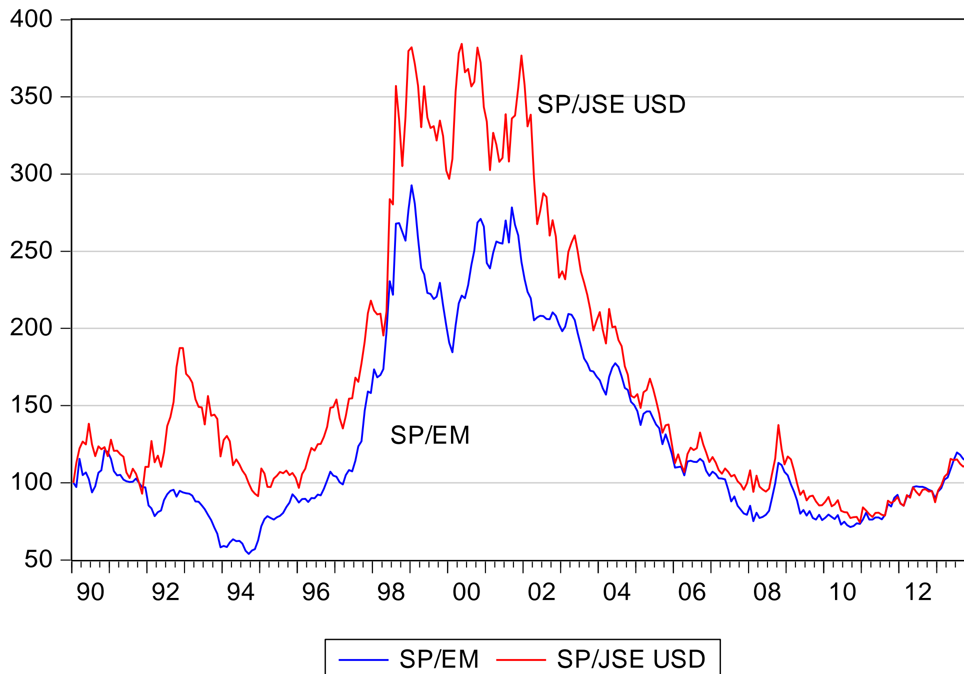
The currently weaker rand can be expected to have a positive impact on the rand and US dollar earnings of JSE listed resource companies, provided dollar prices hold up and most important for mining output in SA, the mines produce normally and are much less disrupted by strike action than they were in 2013.

An expected recovery in JSE resource company rand earnings has already influenced the values currently attached to these companies as may be inferred from the strong uptick in the price to earnings multiple attached to the JSE Resource Index. By the year end Resource Sector earnings per share were 38% down on December 2012 while the Index level itself was down by about a half a percent. The JSE Resource PE ratio rose from 11.12 times trailing earnings in December 2012 to 17.8 times by year end 2013 a rerating that provided the JSE Resource Index with a modest 2.7% total in rand returns in 2013. Though given the weak rand returns in USD were significantly negative. The rand had lost 24% of its USD value of January 1st 2013 value, by year end.

The underperforming EM Index – partly due to the declines in Resource company valuations in USD.

Poor USD dollar returns from EM resource companies, with a relatively high weight in the EM Indexes, helped drag down EM USD returns generally into negative territory not only on the JSE. The bench mark EM Index realised a negative USD return of about 3.41% in 2013 compared to a 28% return provided by the S&P 500 Index. Thus after outperforming developed markets significantly for many years after 2002, emerging equity markets and the JSE were distinct dollar underperformers in 2013.

Fig 7;Relative Performance S&P 500/ EM and JSE (1990=100)



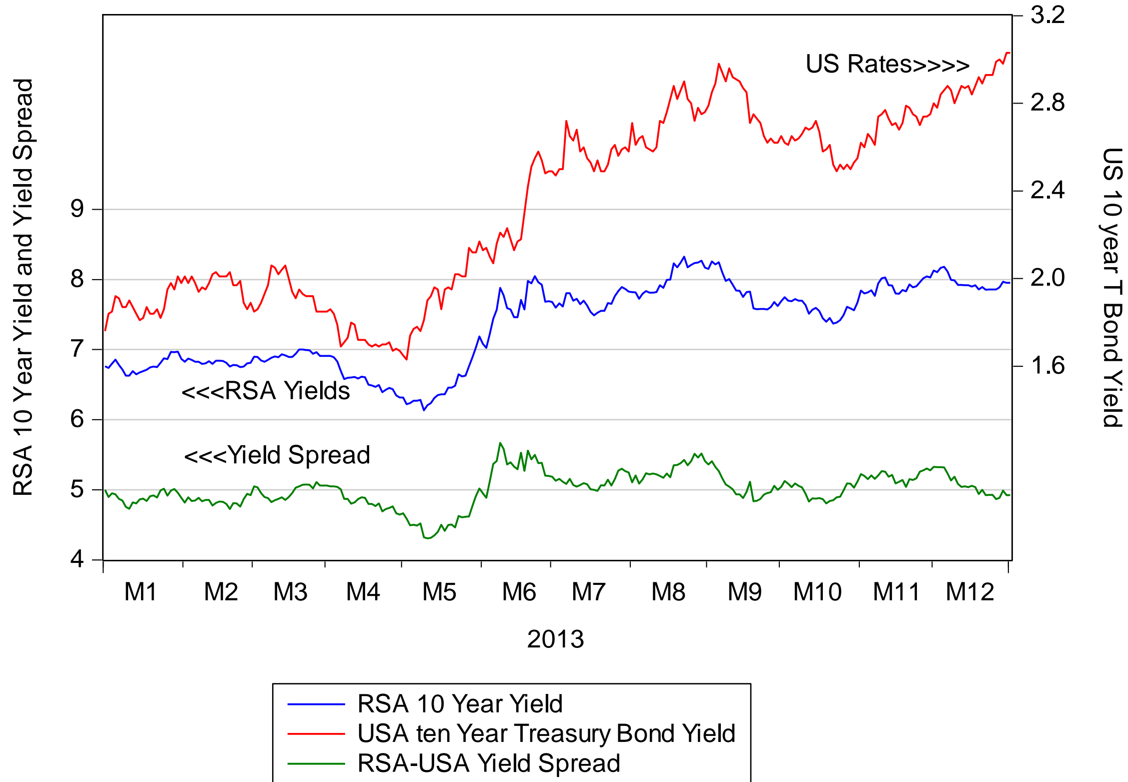
A key question is therefore whether or not they can be expected to underperform as significantly in 2014, or is there reason to expect something of a comeback for EM equities?

The US interest rate effect on EM equities and bonds

Higher long term interest rates in the US surfaced when the prospect of FED tapering of money growth was raised by the US Fed in late May 2013. The developed equity markets welcomed the prospect and reality of higher interest rates as evidence of an unexpected economic revival in the US. Equity and currency markets in the developing world including SA proved much less tolerant of higher interest rates. As funds flowed out of EM equity and bond markets to developed markets on the prospect of higher expected and actual yields EM currencies weakened especially of those economies, the fragile five, Brazil, India, Turkey, Indonesia and South Africa, fragile because their economic growth remains dependent on continuous inflows of foreign savings capital that are needed to compensate for a lack of domestic savings as revealed by persistent deficits on the current foreign trade and debt service accounts of their balance of payments.

The terms for this capital became more onerous in 2013 as interest rates rose in the US, though some relief for the SA and other EM borrowers came after midyear, in the form of a lower risk spread (See figures 8 and 9 below)

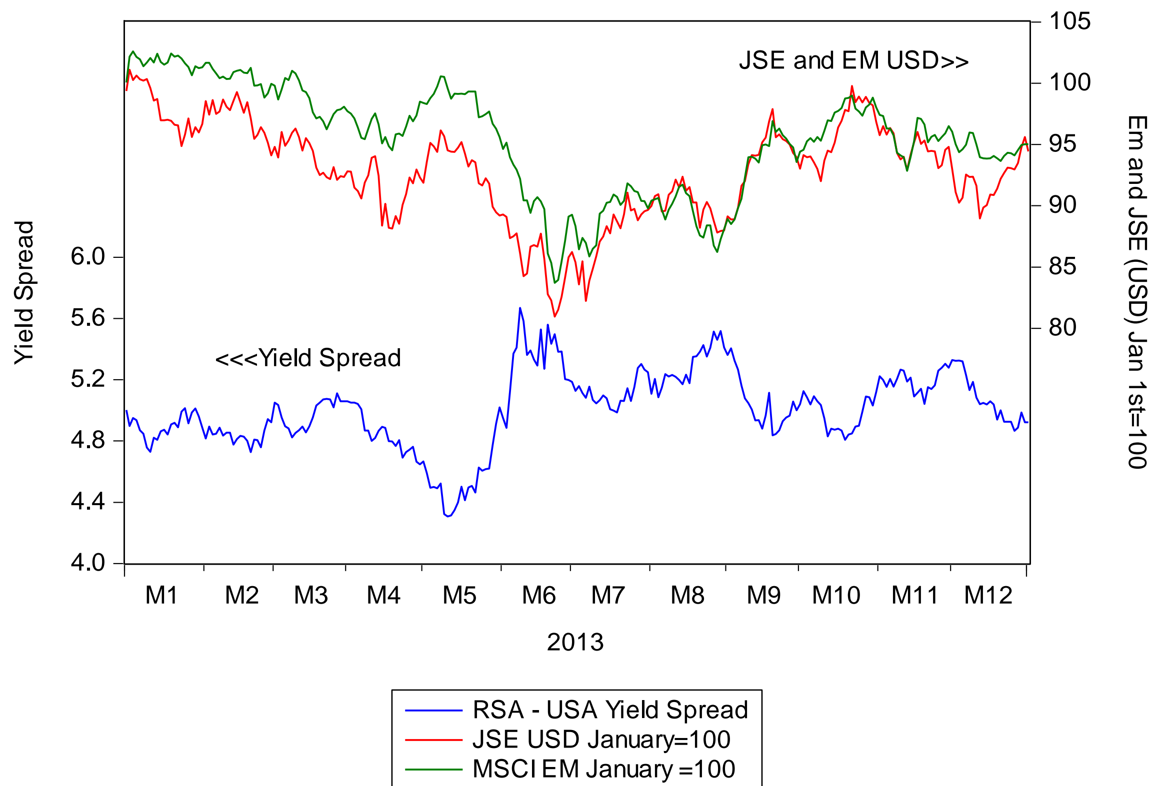
Fig 8: RSA and USA Long Bond Yields and the Interest Rate Spread



Source; I-net Bridge, Investec Wealth and Investment

It seems very clear that higher interest rates in the US and particularly a higher yield spread that indicates a higher EM risk premium, remain a threat to EM equity valuations both absolutely and relatively to values in developed markets. They also remain a threat to emerging market exchange rates including that of the rand VS the USD.

Fig 9; The interest rate spread and the EM and JSE Indexes- in USD (January 2013=100)



Source; I-net Bridge, Investec Wealth and Investment

What has been good news about the US economy has proved good news for US equity markets despite the implications for higher actual and expected long term interest rates. Good news about the US economy is by definition good news about the global economy of which it has a large some 20 per cent share - from which emerging market economies as well as other developed economies - can be expected to benefit, especially in the form of higher volumes of exports from the developing to the developed world.

The potentially helpful influence of faster global economic growth on the values attached to the average listed EM company, has for now, been more than offset by the influence of higher costs of capital for these companies. Perhaps it is a case a case of the risk premium attached to emerging market economies remaining at elevated levels, while the risks of investing in the developed world have receded. Unfavourable political developments in the emerging world, SA, Turkey, Thailand, Brazil and India and Indonesia included and China perhaps not excluded may well have added EM risk - not withstanding a stronger global economy. However a stronger global economy is helpful to emerging market economies and does offer the prospect of higher commodity prices though the role of China as a resource consumer remains the most important influence on the demand for iron ore, copper and coal demands.

At some point in time it can be expected that good economic news will translate into good news for emerging markets- though also helpful to emerging equity markets and emerging market currencies, including the foreign exchange value rand, would be a gradual rather than a sharply upward move in US interest rates.

Why the US economy and the impact it has on US Interest rates will be decisive for financial markets in 2014

The key influence on equity markets in 2014 will be the pace of economic growth in the US and the reactions of the US Fed in the form of more or less tapering of its injections of additional Fed money into the US financial system. While Fed policy determined short term interest rates can be firmly predicted to remain at near zero levels over the next twelve months, the pace of monetary expansion will be, as we have been guided by the Fed, data dependent. If the pace is faster than currently expected long term rates will rise, if slower than expected long term rates can fall from current levels that have tapering expectations built into them. Tapering itself will not be a surprise to the market- only its unexpected pace may be enough to send long term interest rates in either direction should the rate of tapering prove faster or slower than expected. Given that tapering itself as well as the Quantitative Easing (QE) that preceded it is unprecedented these expectations must be regarded as highly tentative and therefore volatile.

For Emerging Equity Markets and their currencies, including the rand, the slower the pace of tapering, the lower will be interest rates and the better for equities and currencies. The S&P 500 however can be expected tol benefit from higher rates of interest that reveal faster than expected US growth as they have reacted in 2013. Similarly commodity prices might also be expected to benefit from unexpectedly good growth in the US- absent any deterioration in Chinese growth rates.

Dealing with upside risks to the US economy

Our view is that upside risks to the US and global growth outlook, with room for a lower US equity risk premium, justify a risk on attitude to global equities with a bias in favour of developed markets. Accordingly this bias extends to the global economy plays listed on the JSE. They are linked to the S&P 500 and offer a hedge against both a weaker rand and weaker EM equities and our tendency would be to maintain an overweight exposure to such stocks in addition to an overweight equity weight in offshore portfolios.

The rand will take its cue from the direction of EM equity and bond markets, absent movement in the SA risk premium that can also affect the ZAR positively or negatively. We regard the rand as fundamentally weak at current exchanges rates of the order of USD/ZAR 10.80. We regard the risks of a move higher or lower over the next three months as about equal and dependent on the direction, magnitude and timing of US Long Bond yields. Over the longer term EM equity

markets might well resist higher global interest rates should these be accompanied by faster growth in EM economies encouraged in a lagged way by the economic recovery in the US.

Without a sustained US recovery interest rates in the US will not rise and improve the case for investing in higher yielding EM bonds that in turn will help support EM currencies. The biggest risk to EM currencies and markets for now is an upside US economic growth surprise and vice versa should the US recovery stall EM equities and currencies will gain USD value.

Given the risk of higher interest rates in the US and in South Africa and so a weaker rand, the SA Industrials have less obvious appeal, compared to the Global Industrial Hedges, despite relatively undemanding valuations attached to SA Industrial plays and despite comparable earnings growth outlooks. Should the rand strengthen then the SA plays would come into their own.

The commodity price plays (resources excluding gold mining companies) however also will do well with rand strength if that strength was associated with a stronger global economy and rising commodity prices in USD. Furthermore if rand strength was accompanied by less SA specific risk, in the form of a better performing mining sector, the commodity price plays can also be expected to perform well on the JSE.

Asset Allocation Summary and Recommendations

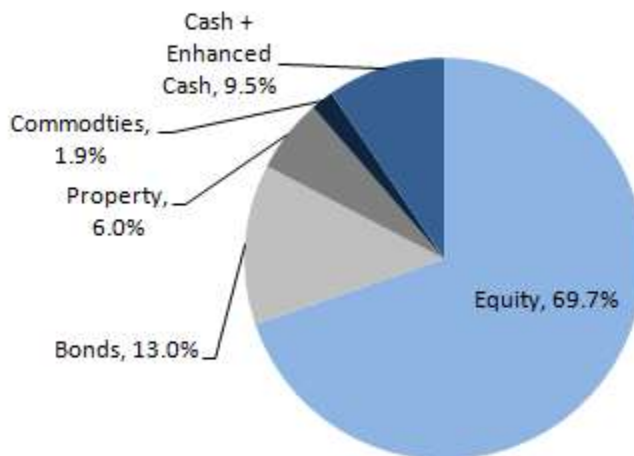
Our advice to the balanced equity fund manager with a twelve month horizon is to remain risk on- with an overweight, relative to benchmark, exposure to equities, especially global equities. Given an expected increase in long dated bond yields we recommend underweight fixed interest exposures, especially to government debt, with a bias in favour of high yielding corporate paper that stands to benefit from a stronger global economy. Given the risks to the rand and so the SA plays we recommend less exposure for a SA pension fund to domestic equities generally and a move back to benchmark weights in cash.

We are however tempted by the improving case for resource companies. Their valuations are unlikely to be interest rate sensitive- particularly because interest rate movements are pro-cyclical as are commodity prices, when expressed in US dollars. The risks of higher interest rates responding to unexpectedly strong global growth are best hedged by the commodity price plays- excluding the gold counters.

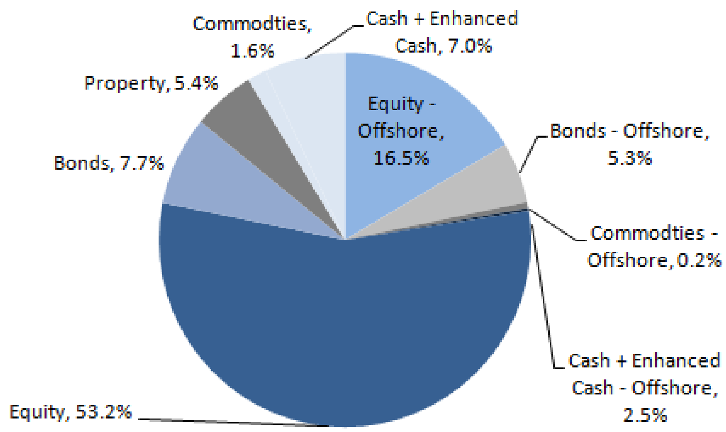
Our recommended asset allocation advice for a higher risk Pension Fund is summarised below and is also compared to our own benchmark (BM) allocations.

Fig 10; Recommended weights

	Domestic	International	Total
Equity	53.2%	16.5%	69.7%
Bonds	7.7%	5.3%	13.0%
Property	5.4%	0.6%	6.0%
Commodties	1.6%	0.2%	1.9%
Cash + Enhanced Cash	7.0%	2.5%	9.5%
	75.0%	25.0%	100.0%



	BM	IWI	OW/UW
Equity - Offshore	15.0%	16.5%	1.5%
Bonds - Offshore	7.5%	5.3%	-2.3%
Property - Offshore	0.0%	0.6%	0.6%
Commodties - Offshore	0.0%	0.2%	0.2%
Cash + Enhanced Cash - Offshore	2.5%	2.5%	0.0%
Equity	48.8%	53.2%	4.4%
Bonds	15.0%	7.7%	-7.3%
Property	3.8%	5.4%	1.7%
Commodties	0.0%	1.6%	1.6%
Cash + Enhanced Cash	7.5%	7.0%	-0.5%


Commodties, 1.6%
Cash + Enhanced Cash, 7.0%
Property, 5.4%
Equity - Offshore, 16.5%
Bonds - Offshore, 5.3%
Bonds, 7.7%
Commodties - Offshore, 0.2%
Cash + Enhanced Cash - Offshore, 2.5%
Equity, 53.2%