PortfolioMetrix BCI Dynamic Income Fund

A brief note on SA bond valuations and some thoughts going into the local elections.

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Key takeaways

- Dynamic Income looks to generate the most attractive yield with full consideration of the risks in the fixed income market,
- The SA 10-year yield has additional risk premia of 75-150bps priced in,
- Short rates and Money Market returns are expected to provide lower returns over the next 6-18 months (the cost of certainty / low volatility),
- Global macro is driving the sell-off of our bonds, there are plenty of positives in SA that will likely be considered post-election:
    - Ports and private operators,
    - Strategic progress being made at Transnet,
    - Outperforming tax collections, reappointment of SARS Commissioner,
    - Eskom, EAF/loadshedding and the split-up,
    - FATF grey listing progress (we have corrected 15 of the 20 outstanding items),
    - Reappointment of SARB Governor (5-year term), further indication of protecting the independence of our institutions,
    - Contained inflation, responsible use of the GFECRA boost, responsible budget,
- Election and event risk is difficult to predict and time, positioning needs to be strategic rather than out-sized tactical positioning,
- Current election uncertainty is actually indicative of the maturing of our democracy - democracy in action, we have not seen populist electioneering or interference in institutions such as the Treasury or the Reserve Bank

Expanding on the key takeaways

Research by both RMB and Standard Bank points to election event having an effect on the market *but not with any reliable predictability*. Similar to Budget and MTBPS events where the market reaction (rally / sell-off) and the actual timing is very difficult to assess. What can be determined:

- current cash/mm rates,
- valuation of SA Bonds,
- global risk sentiment.

This approach allows us to assess the "safety margin" or additional risk- premium in the price, not the event or the market response to that event. At the end of March, we estimated the additional risk premium not described by fundamental factors to be in the region of 75-150bps. Our current 10-year yield is 12.2% (2024/04/30). In short there is significant protection to fixed income investors, this protection comes in two parts:

1. the high entry yield (SA government bonds would need to sell off more than 200bps from current cheap levels in order to generate a negative return),
2. the mean-reverting nature of bonds (this can be evidenced but putting bonds into perspective: whilst equity investors may potentially wait 5-10 years to reap the equity risk premium, bonds pay-off in 1-3 years).

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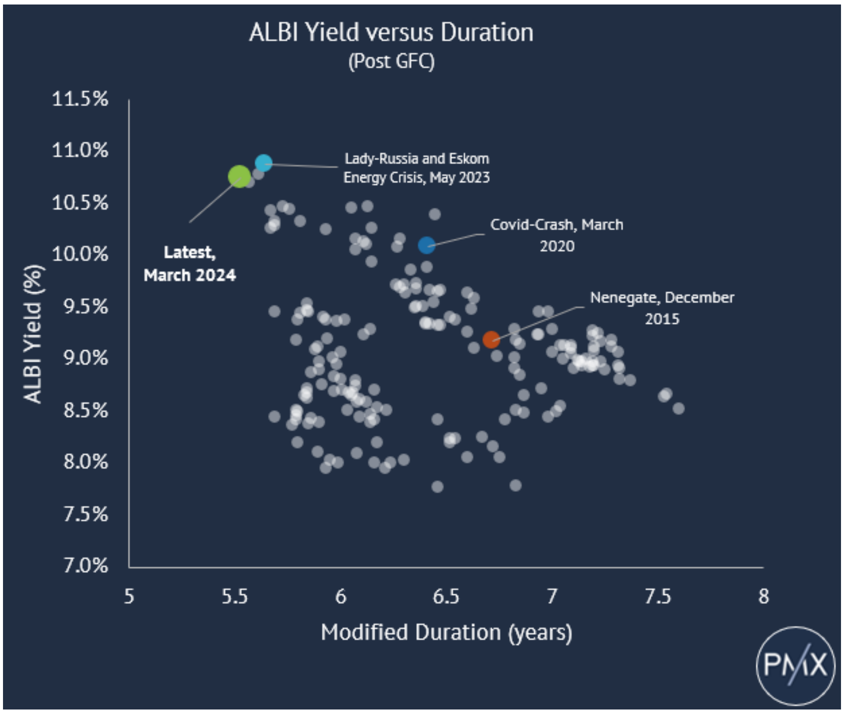
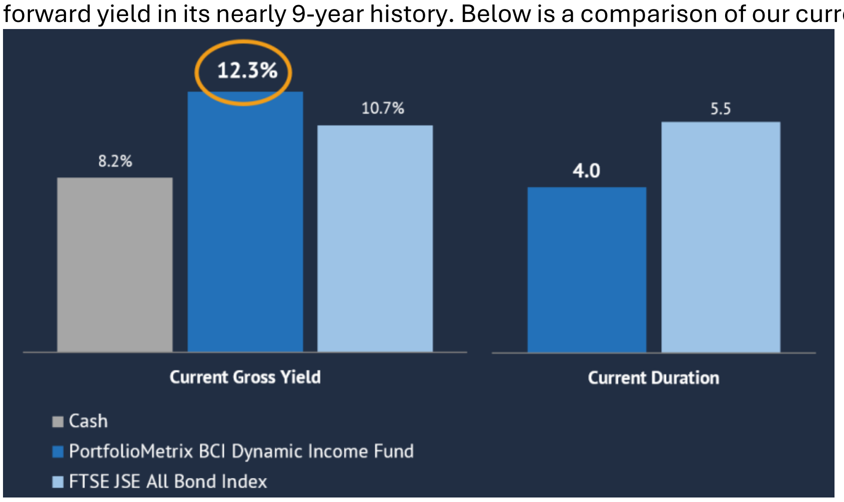
It could easily be argued that a 1–3-year investment horizon is not suitable for many investors, requiring a shorter horizon. That then leads to the way that we manage Dynamic Income; we look to optimise for a high running-yield whilst consistently assessing the opportunity set.

When short rates are, by our assessment, the most attractive part of the fixed income market then we will bias the portfolio towards that with a much lower overall duration (and typically lower yield), we have historically had a duration of 0.9 years. Alternatively, when SA bonds look attractive then we bias the portfolio towards the most attractive bonds. We always do this through careful consideration of risk. Currently, government bonds are offering the highest risk-reward ratio since pre-nenegate (2015) as seen below:



As of 2024/03/31. Source: Bloomberg, PortfolioMetrix. FTSE/JSE All Bond Index Yield and Modified Duration

This very high level of yield versus a lower level of interest rate risk means that we can provide a high forward yield at a very reasonable level of risk. In fact, the Dynamic Income* team strategy is currently showing the highest forward yield in its nearly 9-year history. Below is a comparison of our current positioning versus cash and bonds:



*Source: Financial Express, PortfolioMetrix, Bloomberg. *Current yields and duration figures are indicative (2024/03/31). Income funds derive their income from interest-bearing instruments in accordance with Section 100(2) of the Act. The yield is a gross current yield and is calculated daily.*

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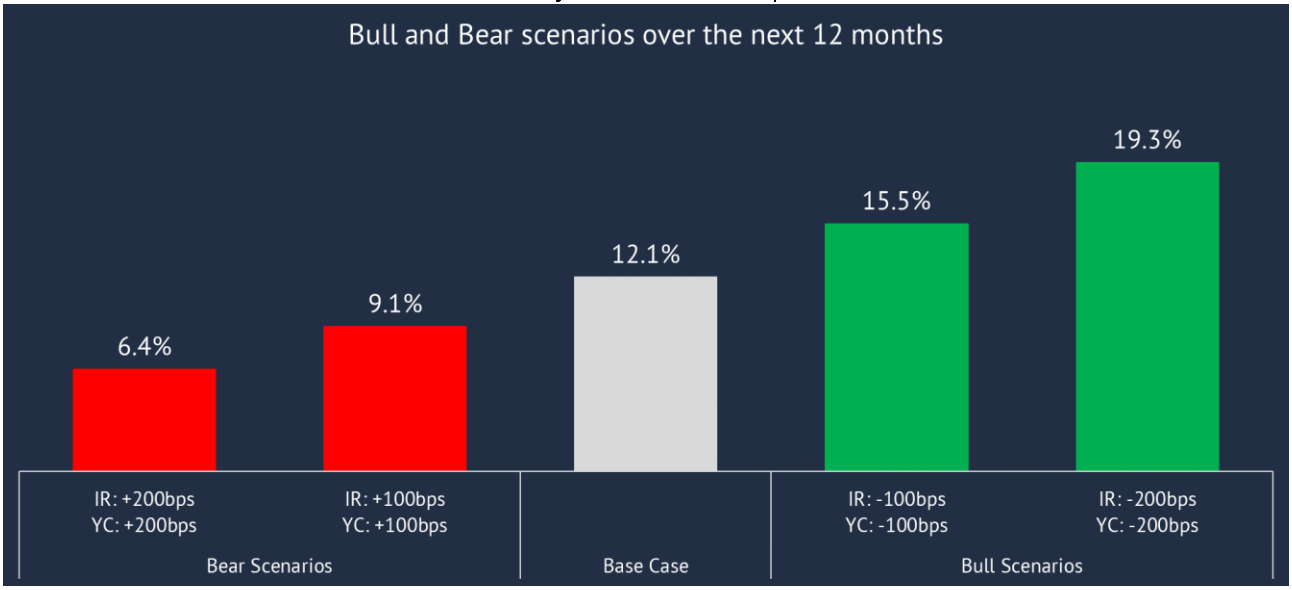
It is apparent from the previous chart that our forward-looking return expectations are 4% above cash and money market instruments, and higher than SA bonds too. What is very important to consider in this is not only our positioning, but also our Bull and Bear scenarios. Portfolio Management is just as much about recognising that you can be wrong, and the impact that has on your investors. Our expectations are still for a repricing of government bonds to better levels and for cash rates to come down as well, but the construction of our portfolio and selection of securities means we have an asymmetric return expectation for different scenarios too:



*Source: Avior, PortfolioMetrix. As of 2024/04/30. Bull scenario accounts for a parallel -1/200bps shift in the yield curve. Bear scenario accounts for a parallel +1/200bps shift in the yield curve. Base case assumes no change in yields. *Current yields and duration figures are indicative (2023/12/31). Income funds derive their income from interest-bearing instruments in accordance with Section 100(2) of the Act. The yield is a gross current yield and is calculated daily.*

The notable takeaway from the above scenarios is that we will produce a real return across these broad range of outcomes, but our base case will generate a *real return* in the region of 7% (above inflation); this is an equity-like return but with greater certainty. Additionally, we expect to generate returns in excess of cash and money market, the ASISA SA MA Peer Group average, and capture most of the SA Bond upside whilst protecting on the downside.

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