GAME OF LOANS: CHOOSING AN INCOME MANAGER

Income fund investing is growing in importance, not only as a provider of income, but also as a real return driver. With a host of different styles and risks out there, how do you choose a manager to best suit your needs?

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"Sometimes return of capital becomes more important than return on capital…"

There are several reasons that you may wish to invest in an income fund – it could be purely for the income; it might be to serve as a stabilising element in a balanced portfolio; or it could offer a temporary warehouse for funds pending their investment elsewhere. In all cases, you need to ensure that your choice of fund manager is based on sound reasoning and not simply because it's a name that is well known or due to their past performance.

There are different approaches to managing income funds. Many funds focus on credit (corporate, parastatal or securitised debt) to increase fund yields. Other funds focus on managing term and duration (interest rate risk) in anticipation of changes in monetary policy or other macroeconomic factors.

There is no right or wrong – it comes down to what you are trying to solve for. For example: how do they fit best into your total investment solution? What are the levels and types of risk you're willing to take?

Here is a guide to help you make an informed decision:

1. **Define your investment objectives**

   Spend time with your financial advisor. Consider your life stage and investment time horizon. Typical points to consider may include:

   - Are you saving in a retirement annuity or are you drawing income from a living annuity?
   - Are you investing on a temporary basis pending an investment elsewhere or is this a long-term investment?
   - Are you using this fund as a stand-alone investment or as part of a larger income or multi-asset solution?
   - Determine the amount of income and liquidity you need from your investments.
   - And lastly, what is your appetite for risk? You need to know your own willingness and ability to adopt risk.

2. **Look at the fund manager's investment strategy – know what type of risk you are buying**

   Although income funds are widely regarded as low-risk investments, there are a few key risks to consider, such as interest rate risk, credit risk and liquidity risk.

   Life is full of trade-offs and so is income investing. Think of the income fund as a portfolio of loans made to a range of borrowers. The yield (interest rate) you receive will typically be higher when you lend out money for a longer term, or when you lend out money to less creditworthy borrowers.

   Aim to understand a fund manager's investment strategy and ensure it's designed to generate consistent and sustainable income. Examine how the fund allocates investments across different fixed income asset classes and verify that the manager maintains this strategy over time. This consistency will come through in performance over time.

   Most funds target 1% to 2% outperformance above the South African Short Term Fixed Interest (STeFI) Composite Index over shorter periods, typically 12 months, while utilising some key drivers of return. Currently this equates to a targeted return of around 10% per annum.

   Popular investments made by income managers include:

   - Government debt in the form of listed nominal bonds, inflation linked bonds or treasury bills.
   - Fixed deposits and Negotiable Certificates of Deposit (NCDs) issued by Banks.
   - Subordinated bank debt.
   - Corporate debt.
   - Parastatal, SOE and municipal debt.
   - Securitised debt (pools of small loans e.g. mortgages, credit cards or vehicle financing)

   It becomes clear that the credit quality can vary considerably between these types of loans. In some cases, the return of capital becomes more important than the return on capital.

3. **Review performance metrics**

   Look for income fund managers with sufficient experience in income-focused investing and examine their track record, focusing on performance across different market cycles. Look beyond the latest performance for funds that deliver on their promise (target) consistently. It's no good chasing last year's winner, just to chase the next winner next year, while not actually participating in that upside.

Although income funds are more focused on capital preservation and risk management, they can also provide attractive real returns over inflation. These returns, like riskier assets, don't come in a straight line. Income funds are not guaranteed. They can have the occasional negative month. Although most aim not to have any negative quarters.

If the style of the income fund manager focuses on corporate and other credit exposure, are they capable of demonstrating robust credit assessment skills to manage default and liquidity risk.

Examine the current and historical yield of the fund and look at both income and capital appreciation by looking at the total return. And be aware whether the performance is related to the entire market or the manager's own abilities – as John F. Kennedy famously said "A rising tide lifts all boats."

One interesting contradiction is that income funds that tend to perform very well (or offer very high levels of yield) may actually present much higher levels of credit risk, illiquidity or term risk. If the numbers seem too good to be true, they usually are.

4. Evaluate risk management practices

"Rule No. 1: Never lose money. Rule No. 2: Never forget Rule No. 1."

Warren Buffet

Performance generally requires a trade-off with risk – to achieve higher performance one must usually take on greater risk. These risks will not always hide in plain sight and can be difficult to identify.

Consider that there are various types of loans issued by high-quality borrowers – such as SA government and big banks – that may offer yields in excess of the 10% per annum target. Now, if a manager is holding an underlying security, let's say something like securitised motor vehicle loans, that is yielding 15% per annum, then you need be realistic about the risk associated in realising that yield.

Be prepared to investigate the risk management techniques of the manager and look for strategies that include measures to protect against significant losses, such as diversification or hedging. Ensure the fund is well-diversified across different sectors and fixed income asset classes and review the credit quality of fund holdings.

Another interesting contradiction is that the standard deviation of past returns does not tell you anything about credit risk. To the contrary, most high yielding corporate and securitised debt instruments tend to show very little price volatility over time.

Safety first

Our income fund approach at Matrix Fund Managers is very much safety first. When assessing the different drivers of return, we favour those fixed income asset classes that will assist us in achieving our target performance with the least amount of risk. We achieve that through focusing on highly liquid securities with very low credit risk. We overlay thorough macro analysis and market research with proven in-house skill and robust processes to deliver on target outcomes.

This safety-first approach has delivered compelling returns over time, in line with investor expectations on risk and volatility, without adopting unnecessary risk.

A summary of our income fund offering as at May 2024 is as follows:

	Matrix SCI* Stable Income Fund	**Matrix SCI* Enhanced Income Fund**
ASISA Category	SA - Interest Bearing - Short Term	SA - Multi Asset - Income
AUM	R 7 900 million	R 1 100 million
Benchmark	STeFI Composite Index	STeFI Composite Index
Return target	STeFI Comp + 1% after fees Positive rolling 3M returns	STeFI Comp + 2% after fees Positive rolling 3M returns
Product Features	Very High Liquidity Very Low Credit Risk Zero exposure to REITs and shares SA and ZAR focus	High Liquidity Low Credit Risk SA and Inward Listed Foreign assets
Sources of Return	Money Market Term Structure Inflation Linked Assets Floating Rate Term Structure Fixed Rate Term Structure Credit not a return driver	Money Market Term Structure Inflation Linked Assets Floating Rate Term Structure Fixed Rate Term Structure Selected high quality credit
Modified Duration	Max 2Y duration limit Typically 1.0Y to 2.0Y	Max 4Y duration internal limit Typically 1.5Y to 3.5Y

**Sanlam Collective Investments*

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About the author

André is the Head of Retail at Matrix Fund Managers and is responsible for distribution and client relations. André joined Matrix in 2023 and has 14 years' experience in the investment industry. He started his career in Gauteng, working as an investment specialist for one of South Africa's leading LISP's and Life insurers. Prior to joining Matrix, André was the Regional Manager for Glacier Invest within the Sanlam Investments Group for 7 years. He holds a BCom Degree in Economics from the North-West University in Potchefstroom.

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