What has happened in the market and Diversified Income Fund's performance to now (year-to-date 27 March 20)?

By Peter Kent, Co-Head of SA Fixed Income at Ninety One

With the unprecedented selling of government bonds, even our small duration position has resulted in a capital loss. Inflation-linked bonds have been caught in the same crosscurrents and have also detracted from performance. Listed property as a sector has halved in value over the last quarter and been a significant detractor (despite having a strategic underweight). Our offshore position has offered some protection and so too has the income earned in the fund. We expect a negative quarter, but the portfolio aims to eliminate withdrawals on a six-monthly basis. Our views going forward are discussed in more detail below, but with market valuations where they are and the income on offer going forward we anticipate returns improving over the remainder of the year.

So where are we fundamentally on bonds?

INFLATION AND INTEREST RATES OUTLOOK

The first glaring point to note is that there is absolutely no inflation anywhere in SA given the oil price shock (on the back of the Saudi Arabia/Russia price war) and the current demand shock. The South African Reserve Bank (SARB) targets 4.5% inflation, being the midpoint of a 3% to 6% range. The only scenario where we forecast inflation threatening the top end of the band is where oil virtually triples and the rand goes to R21 against the dollar. Most plausible scenarios show inflation below the midpoint of the band, and growth for the year will be comfortably negative. This leaves the SARB with

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room to cut rates materially from the current level of 5.25% possibly to below 4%, and soon (most likely before the May scheduled meeting).

If you overlay a repo rate of somewhere near 4%, a banking system that is being flooded with SARB liquidity and regulatory loosening, and the SARB supporting the secondary bond market - the R186 (5.5-year bond) yielding above 11% seems incredible value. The main risk is volatility and, therefore, appropriate position sizing. Longer-dated bonds, with less anchoring to the SARB, and more fiscal risk, don't seem as appealing to us.

CURRENCY OUTLOOK

On the rand – part of the reason it has done better than some of its EM peers over this crisis period has been due to our Terms of Trade improving. SA is an oil importer and precious metal exporter, and given the market moves over the last month both of those have moved materially in our favour as a country (oil lower, gold higher). The problem is that due to the demand and supply shock rippling through the globe, there is very little trade happening and as a country we can't reap this income benefit (in other words, the price of our exports/imports has improved but the quantity has deteriorated). The currency has therefore been caught in the cyclical crosscurrents affecting all emerging markets, and has depreciated.

Unless a swift improvement in COVID-19 news materialises (which we think is unlikely), it is hard to see the rand snap back to the pre-crisis levels. One of the biggest investment themes post COVID-19 will be a world digesting eye-watering amounts of fiscal stimulus, and the competition for global capital will be a lot harder than the last decade. SA may find itself (with other EMs) at the back of the capital queue, and we will therefore keep our offshore allocation higher than we have over the last few years.

HOW WILL DIVERSIFIED INCOME'S PERFORMANCE BE AFFECTED GOING FORWARD?

We expect performance to remain volatile with a few more ups and downs than usual – this is an inevitable consequence of the market finding its feet after a black swan event. We will remain risk conscience throughout and have a preference for liquidity.

One of the positives of the bond market rerating so materially and credit spreads widening is that incomes are higher. Despite cash rates in the 6%s (and heading lower fast) the fund is currently yielding 8.25% while still being defensive: with very little duration, listed property and a high offshore allocation. Over the coming weeks, we anticipate, in a very measured fashion, increasing our duration closer to 1 to 1.25 year and increasing our listed property by 1% (to 2%). These minor changes will increase the yield to 9%. Capital returns will remain choppy and through the various policy initiatives will hopefully not detract much more from income.

The sudden stop to the global economy brought on by COVID-19 has been a shock to us all, and a shock to the global capital markets. South Africa is unfortunately at the forefront of the vulnerability. We will remain engaged with policy makers, and focused as a team to deliver the best possible outcomes over the coming months.

Disclaimer

Nothing contained here should be construed as financial advice

CIS disclosures: Long only portfolios (CIS in securities)
Risks (portfolio specific)
Derivatives: There is no assurance that a portfolio's use of a derivative strategy will succeed. A portfolio's management may employ a sophisticated risk management process, to oversee and manage derivative exposures within a portfolio, but the use of derivative instruments may involve risks different from, and, in certain cases, greater than, the risks presented by the securities from which they are derived.
Exposure to foreign securities: Foreign securities within portfolios may have additional material risks, depending on the specific risks affecting that country, such as: potential constraints on liquidity and the repatriation of funds; macroeconomic risks; political risks; foreign exchange risks; tax risks; settlement risks; and potential limitations on the availability of market information. Fluctuations or movements in exchange rates may cause the value of underlying international investments to go up or down. Investors are reminded that an investment in a currency other than their own may expose them to a foreign exchange risk.
Money market portfolios: A money market portfolio is not a bank deposit account. A constant price (CNAV) is applied to a participatory interest. The total return to the investor is made up of interest received and any gain or loss made on any particular instrument, and in most cases the return will merely have the effect of increasing or decreasing the daily yield, but in the case of abnormal losses, it can have the effect of reducing the capital value of the portfolio. Excessive withdrawals from the portfolio may place the portfolio under liquidity pressures, and in such circumstances a process of ring-fencing of withdrawal instructions and managed pay-outs over time may be followed.
Fund of funds: A fund of funds is a portfolio that invests in portfolios of collective investment schemes (unit trusts) that levy their own charges, which could result in a higher fee structure for the fund of funds.
Feeder funds: A feeder fund is a portfolio that invests in a single portfolio of a collective investment scheme, which levies its own charges and which could result in a higher fee structure for the feeder fund.
Drawdown: The potential magnitude of loss - the largest peak-to-trough decline in returns over the period, also known as the maximum drawdown.
Liquidity: The risk that a given security or asset cannot be traded quickly enough in the market to prevent a loss (or make the required profit).
Equities: The value of equities may vary according to company profits and future prospects, as well as more general market factors. In the event of a company default, the owners of their equity rank last in terms of any financial payment from that company.
Bonds: The value of fixed income investments (e.g. bonds) tends to decrease when interest rates and/or inflation rises. Bonds issued by major governments and companies, will be more stable than those issued by emerging markets or smaller corporate issuers. If an issuer experiences financial difficulty, there may be a risk to some, or all, of the capital invested. Any historical or current yields quoted should not be considered reliable indicators of future performance.

For a detailed description of these risks, and other risks that are relevant to the portfolio, please refer to the CIS risk disclosure document, available on the website **www.discovery.co.za**.

General
Collective Investment Schemes (unit trusts) are generally medium to long-term investments. The value of participatory interests (units) or the investment may go down as well as up. Past performance is not necessarily a guide to future performance. Collective investment schemes are traded at ruling prices and can engage in borrowing and scrip lending (i.e. borrowing and lending of assets). The manager does not provide any guarantee, either with respect to the capital or the return of a portfolio. Any forecasts and/or commentary in this document are not guaranteed to occur. Different classes of participatory interests apply to these portfolios and are subject to different fees and charges. A schedule of all fees and charges, inclusive of VAT and maximum commissions, is available on request from us or from your financial adviser. Forward pricing is used.

Redemptions
The collective investment scheme may borrow up to 10% of the market value of the portfolio to bridge insufficient liquidity. The ability of the portfolio to repurchase, is dependent upon the liquidity of the securities and cash of the portfolio. A manager may suspend repurchases for a period, subject to regulatory approval, to await liquidity, and the manager must keep the investors informed about these circumstances.

Yields
The yield for bond, income and money market portfolios is historic and is calculated quarterly.

Prices
The latest prices and TERs are published daily in the Business Report (South Africa's National Financial Daily) and are made available on our website **www.discovery.co.za**.

Performance fees
Performance fees are not levied on the portfolios.

Performance returns
Lump-sum performance returns are being quoted. Income distributions, prior to deduction of applicable taxes, are included in the performance calculations. NAV to NAV figures have been used for the performance calculations, as calculated by the Manager at the valuation point defined in the deed, over all reporting periods. Investment performance calculations are available for verification upon request by any person. Reinvestment of income is calculated on the actual amount distributed per participatory interest, using the ex-dividend date NAV price of the applicable class of the portfolio, irrespective of the actual reinvestment date. The performance is calculated for the fee class. The individual investor performance may differ, as a result of initial fees, the actual investment date, the date of reinvestment and dividend withholding tax. The rate of return is calculated on a total return basis, and the following elements may involve a reduction of the investor's capital: interest rates, economic outlook, inflation, deflation, economic and political shocks or changes in economic policy. Annualised returns are period returns re-scaled to a period of one year. This allows investors to compare returns of different assets that they have owned for different lengths of time. All period returns greater than one year have been annualised. Returns for periods less than one year have not been annualised. A cumulative return is the aggregate amount an investment has gained or lost over time, independent of the period of time involved. Actual annual figures are available to the investor on request. Illustrative investment performance is for illustrative purposes only.

Valuations and transaction cut-off times
Pricing date is daily, except weekends and public holidays. Valuation point is at 16h00 on each pricing date, except at month-end, where it will be at 17h00. Offers to repurchase participatory interests must be received by 16h00 on each pricing date.

Additional information
For additional information on the portfolio, refer to the following documents, available on our website, from your financial adviser, or on request from the manager, free of charge.

- Application forms
- Annual report
- Fee schedule
- Quarterly General Investor Report

Complaints and conflicts of interest
The complaints policy and procedure, as well as the conflicts of interest management policy, are available on our website **www.discovery.co.za**. Associates of the manager may be invested within certain portfolios, and the details thereof are available from the manager.

Closure of the portfolio
The manager has the right to close certain portfolios to new investors, in order to manage them more efficiently, in accordance with their mandates.

Contact details
CIS Manager
Discovery Life Collective Investments (Pty) Ltd, registration number 2007/008998/07, 1 Discovery Place, Sandton, 2196, www.discovery.co.za. The manager is registered as a manager of collective investment schemes, in terms of the Collective Investment Schemes Control Act. The manager, through Discovery Holdings Limited, is a member of the Association for Savings and Investment South Africa (ASISA).

Trustee
Standard Chartered Bank (Johannesburg Branch), registration number 2003/020177/10, 2nd Floor,115 West Street, Sandton, 2196, P O Box 782080, Sandton, 2146, www.standardchartered.com/za. The trustee is registered as a trustee of collective investment schemes, in terms of the Collective Investment Schemes Control Act.

Investment Manager of the Discovery Aggressive Dynamic Asset Optimiser Fund of Funds, Discovery Conservative Dynamic Asset Optimiser Fund of Funds, and the Discovery Moderate Dynamic Asset Optimiser Fund of Funds

Riscura Invest (Pty) Ltd, registration Number 2009/015999/07, FSP number 40909, Monclare Place corner Campground & Main Road, Claremont, Cape Town, P O Box 23983, Claremont, 7735, 021 6736999.

Investment Manager of all other portfolios
Investec Asset Management (Pty) Ltd, registration number 1984/011235/07, FSP number 587, 36 Hans Strijdom Avenue, Foreshore, Cape Town, 8001, www,investecassetmanagement.com, 0860 110 161.

The investment managers are authorised financial services providers (FSP), as discretionary FSPs, in terms of Section 8 of the Financial Advisory and Intermediary Services Act (FAIS). This information is not advice, as defined in FAIS. Please be advised that there may be representatives acting under supervision.