

PORTFOLIO MANAGER COMMENTARY

The fund had a phenomenal year, returning 10.5% and outperforming cash by over 5%. This return was achieved by locking into attractive real interest rates from inflation-linked bonds before these rallied, hedging interest rate risk at appropriate times and having an allocation to offshore bonds which provided superior yields versus their local equivalents.

The All Bond Index registered a return for the year of 8.80%, quite pedestrian and without much capital gain. The best performing domestic bond was the R203 (2017 maturity) which generated a return of 10.80%, while the worst performing bond in the index was the ultra long dated R209 (2036 maturity), returning only 2.70%. This outcome was a result of the yield curve steepening during the year.

Inflation-linked bonds had a stellar year with the index returning 13%. The 5-year government inflation-linked bond produced 16.5%, the top return amongst the bonds in the inflation-linked index.

Yields on very short dated inflation-linked bonds went negative (R189 2013 maturity), closing the year at a real yield of -0.15%. This was fuelled by demand for inflation protection, which increased sharply as headline inflation breached the upper end of the Reserve Bank's target range. Short-term money market rates of 5.5% are now returning a negative real return, something we have not seen in South Africa for many years.

2011 was characterised by a combination of rising inflation, a depreciating currency (the rand lost 22% against the US dollar), rocketing food prices and a materially increasing fiscal deficit; all of which would normally be negative for the bond market. Despite this, global growth concerns, plunging global bond yields (10-year US Treasury is now yielding less than 2%), worries over the fiscal situation of a number of European countries, continued foreign bond investor appetite for yield along with record low domestic short-term interest rates, resulted in a decent offset to the fundamental negative backdrop for bonds.

As we move ahead into the new year, we expect inflation to remain above the upper end of the 3% – 6% target range during the course of 2012. The main drivers appear to be rising food prices combined with the currency depreciation experienced last year. The maize price again reached new highs in December, with the year-on-year percentage change at 99% for the last 12 months. This has a direct and negative impact on inflation.



The next move in short-term interest rates, we believe, is likely to be up. However, given the relatively dovish stance of the Monetary Policy Committee, this will most likely only take place towards the second half of the year.

With US Treasuries yielding less than 2%, a sell-off in global bonds is a major risk to the domestic bond market, especially combined with the large South African government bond funding requirements we face this year. If the Reserve Bank waits to take action against the rising inflation trend there could be major ramifications for the local bond market – the longer they wait, the more entrenched higher inflation expectations become.

The fund's inflation-linked bond exposure at 17.25% has provided inflation protection as rising inflation is directly factored into the bond's total return. As inflation rises, so does the return on these bonds. The corporate bond holding has also delivered good returns as corporate spreads have compressed in this environment of limited issuance and the search for yield.

Money market exposure has taken the form of long dated NCDs yielding 8% or more per annum for up to five years and, where appropriate, we hedge this out to reduce interest rate volatility. We acknowledge that investors in this fund seek interest yield, thus we aim to deliver a good long-term interest rate over money market and at times capital gains are achieved as well.

The philosophy of this fund is to bring home a steady income, whilst trying to protect capital.

Portfolio managers

Mark le Roux and Tania Miglietta