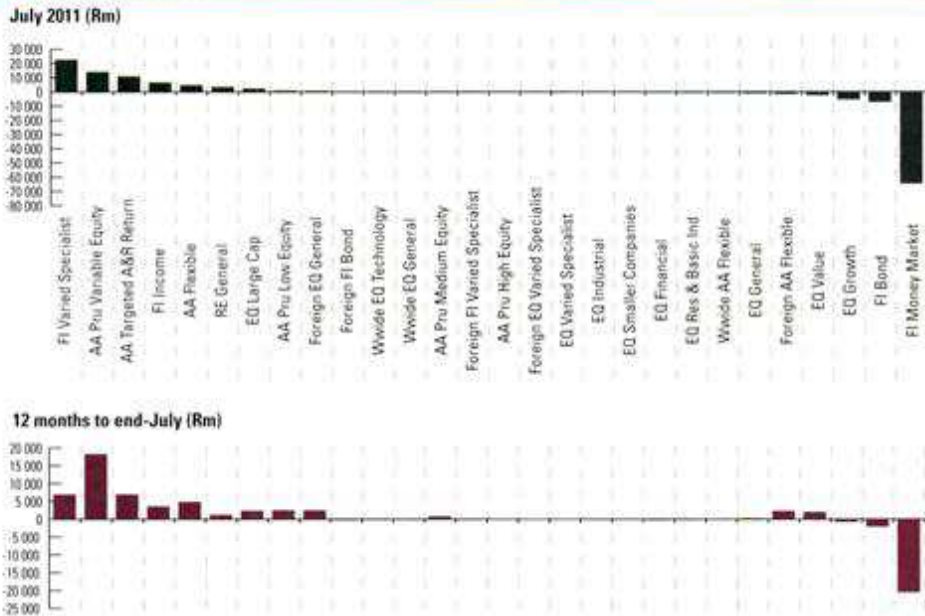


OVERVIEW OF THE MONTH

Safety first amid market jitters

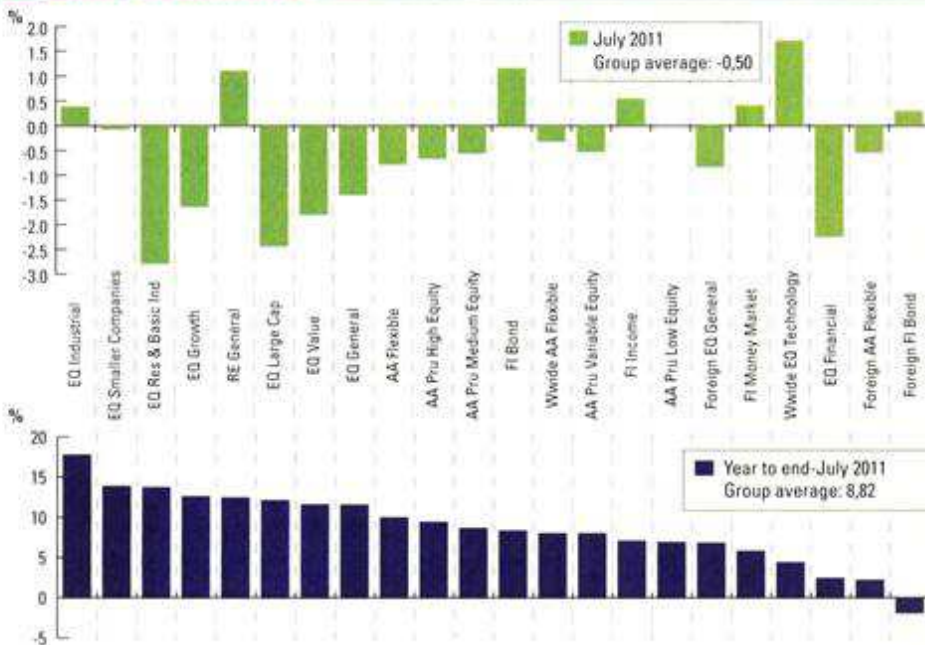
FUND FLOWS



Fund flows show estimated net contributions or withdrawals to/from funds classified by fund category. All funds domestic except foreign and worldwide.

Source: Morningstar

FUND PERFORMANCE



Fund performance shows the % change for one month and the past 12 months. All funds domestic except foreign and worldwide.

Source: Morningstar

THE DOMESTIC Fixed Interest Varied Specialist category has rebounded from outflows of R7,7bn between January and June this year to record the highest net inflows in July of R2,4bn.

The next highest flows were a net R1,4bn into the Domestic Prudential Variable Equity sector. This rebound has been led by the Prudential High Interest (R773m), Investec Absolute Income (R562m) and Momentum Cash Management (R483m) funds and may be a result of investors looking for safety in fixed interest funds as global markets lost momentum during the last week of July.

The highest outflows were recorded by the Domestic Fixed Interest sector which shed nearly R6,4bn during July. This sector has now had outflows of close to R18bn over the past year.

At asset management firm level July's action came from Coronation which received inflows of R1,6bn, taking its past year's inflows to just more than R19,5bn. A close second was Prudential with inflows of R1,4bn for July.

Most categories turned in a negative performance for July, which marked the early stages of the global sell-off.

Retail was again the outstanding sector, gaining 1,1%, to bring its return over the past 12 months to 12,5%. **IM**

About Asisa categories

Every SA-registered investment fund is overseen by the Association for Savings and Investment South Africa. Asisa has defined a system of fund classification into different categories. The first level is about geography of investment universe: domestic have only SA assets, worldwide have both SA and foreign assets, and foreign have only non-SA assets. The next level is about the asset class of the fund investment mandate: equity, fixed interest, real estate, or asset allocation portfolios. The last one invests across multiple asset classes. Under equity there is another layer of classification according to the type of investment style or industry specialisation. These are general, which can invest in any type of equity category, growth which aim to identify fast-growing stocks, value which aim to pick undervalued stocks, large cap, smaller companies, mining companies, financial companies, and industrial companies. A final category captures other funds that don't fit into the others, varied specialist portfolios. Under asset allocation portfolios are prudential (which means they meet retirement fund rules) low equity, medium equity and high equity, which each have defined maximum or minimum equity limits, flexible which have no such limits, and targeted absolute return or real return portfolios. Under fixed interest are bond, income, money market and varied specialist portfolios. Real estate has only one category.

Keeping it real with capital growth

BY WARREN DICK

BEATING INFLATION



FIRST, DON'T BE put off by the name. Then take a deep breath and repeat after me: the domestic asset allocation targeted absolute and real return sector is the name chosen to identify funds that seek to preserve and grow the capital of investors, in real terms. Real of course means any return that is greater than inflation. And inflation in the context of our country is defined by the consumer price index (CPI) as measured by Stats SA and reported widely in the media.

The script goes something like this: at the end of the day the basket of household goods and services that Stats SA chooses to use is supposed to represent the "average" cost of living. And at the end of the day, an absolute return (I'll use the abbreviated version) fund manager's sole purpose is to make sure that your investments grow faster than the cost of living.

Let's use the US as an example. With inflation now running at 4,5% a year, banks are offering investors approximately 0,5% a year to put their money with them. Attractive? Clearly not so much.

The difference (-4%) represents the

rate at which your money is declining in its purchasing power on an annual basis. For people such as retirees who rely on the income from their investments for their livelihood, negative real interest rates are simply not an option. So it's exactly this type

of investor that would find an absolute return fund appealing, and this would include people about to retire as well.

The underlying philosophy of the sector is to get just enough exposure to risk – by way of equities – to pursue inflation-beating returns, while keeping this exposure sufficiently small so that the fund does not incur capital losses over any 12-month period. It is a balancing act that the fund managers engage within the context of their view of the world as well as the mandate that they are ultimately responsible for fulfilling.

As most of the funds we reviewed were Regulation 28-compliant (able to be invested in by a pension fund), equities were limited to a maximum of 75% of the portfolio. Owing to the cautious environment created by the sovereign debt situation in the EU and US, all of the fund managers we spoke to were well within this limit.

Where equities serve a volatile but vital role in chasing real returns, fund managers turn to conventional government bonds and money market instruments to ensure returns that can be banked on, even if they are a little bit shy in delivering what's

required as set out by their mandates. The regular and steady income provided from these instruments allows the fund managers to offset any losses they may have incurred in the equity component of the portfolio.

Our discussions with fund managers revealed that they are keeping the duration of their bond portfolio very short, which means they have been buying bonds that are set to mature in the next six to 24 months. This keeps the portfolio responsive to any changes in interest rates over the period and prevents the portfolio from losing out when rates begin to rise.

But the "go to man" for many of the portfolios are the inflation-linked bonds (ILBs). These instruments are issued by national governments as well as by certain corporate and quasi-government institutions.

Fund managers refer to these bonds as the anchor of their portfolios, as they are guaranteed to pay a margin above inflation, regardless of what inflation may be. To give you an idea: a typical government ILB pays an interest rate of approximately 2,5% above inflation, whereas corporate ILB's can vary between 3% and 3,5% above inflation.

This sector of funds encompasses mandates that can vary quite significantly in the returns they target, and by implication in the risk that they are prepared to assume. For instance the Absa Inflation Beater fund run by Errol Shear is a very conservative portfolio that targets a return of CPI plus 3%. At the other end of the scale you find the Cadiz Equity Ladder run by Francois Finlay that seeks to target a return of CPI plus 6%.

One thing seems clear from our review; the fund managers have achieved what they set out to do, and inflation – for now – has been firmly put in its place. **IM**

ABSA INFLATION BEATER FUND

Performance to end June		
Period	Cumulative return	Rank **
Six months	2,62%	12
One year	7,44%	37
Three years*	9,63%	11
Five years*	8,36%	13

Fund size (Rm): 504
Total expense ratio: 1,45%

*annualised return ** Domestic asset allocation targeted absolute and real return sector

Source: Morningstar

QUESTION: who do you put in the slips? Answer: someone with a safe pair of hands. And that is exactly what the Absa Inflation Beater Fund managed by Errol Shear is to investors: a safe pair of hands. That's because the fund has returned 9,6% a year after fees for the past three years, while inflation has been averaging 5,4%. And it has managed to do this while keeping volatility down to a minimum – 2,49% since inception.

Shear states that preservation of capital comes first, and admits to utilising the full equity allocation only once in the last few years. When he does venture into the equity market it is to buy stable companies with dividend flows that are relatively assured, and he enjoys acquiring balance sheets that have good old-fashioned hard assets behind them.

Pursuing inflation-beating returns means Shear is a regular customer at the inflation-linked bond desk. These instruments – otherwise known as inflation linkers – account for 45% of the portfolio, and the reason Shear likes them so much is because they typically pay a small margin above CPI. Because of this fact they form the long-term core of the portfolio.

To bolster yield while protecting capital, Shear also invests in floating rate bonds, primarily issued by banks. These are usually at rates individual investors on their own would never see. Shear also buys the shorter-dated paper by way of money market instruments that have maturities of not longer than 12 months.

This accounts for about 22% of the portfolio and ensures things stay nice and liquid.

Don't expect any dropped catches from this fund. **AI**

NEDGROUP INV POSITIVE RETURN FUND

Performance to end June		
Period	Cumulative return	Rank **
Six months	1,48%	31
One year	6,53%	41
Three years*	7,88%	16
Five years*	9,35%	10

Fund size (Rm): 5,241
Total expense ratio: 0,77%

*annualised return ** Domestic asset allocation targeted absolute and real return sector

Source: Morningstar

WHEREVER THERE IS risk there is protection, is the mantra of the Nedgroup Investments Positive Return Fund, managed by Prescient investment management.

Chief investment officer Guy Toms explains that the fund uses a quantitative approach in its aim of achieving returns of inflation plus 4%, while striving to incur no losses over a 12-month period.

This makes the fund particularly appealing to people that are nearing retirement, says Toms. You still want to participate in growth assets – like equities – but not at the expense of incurring capital loss.

Key to ensuring that your capital is always protected, the fund makes use of options and futures to prevent any downside risk. This essentially means that investors give up some of their upside potential in order to “buy insurance” to prevent the downside loss.

In order to construct a perfectly hedged portfolio, Toms buys shares listed in the Top 40 index for the equity component of the portfolio, and then uses AlsI 40 futures and options to insure against any losses they may incur.

When making his asset allocation decision, Toms evaluates how much

insurance he can buy for the portfolio first, which is usually a function of interest rates and volatility in the market. If the situation affords him the opportunity to buy insurance cheaply, then he increases the exposure his portfolio has to equities. At the moment half of the portfolio is invested in equities, which is fully protected against any loss.

With interest rates in SA now approaching zero in real terms, Toms invests a chunk of the portfolio into inflation-linked bonds where they are available in the market. These investments “anchor” the portfolio by ensuring that a margin above inflation is always received, which is something that investors in this fund have been getting used to over the past five years. **AI**

CORONATION CAPITAL PLUS

Performance to end June		
Period	Cumulative return	Rank **
Six months	2,50%	14
One year	13,42%	7
Three years*	12,56%	3
Five years*	11,18%	4

Fund size (Rm): 10,066
Total expense ratio: 2,01%

*annualised return ** Domestic asset allocation targeted absolute and real return sector

Source: Morningstar

KEEPING IT REAL is a concept the Coronation Capital Plus Fund understands very well. Led by Louis Stassen and Henk Groenewald, the fund aims to achieve returns of CPI plus 4%. So far the fund has been delivering real returns – that is returns over inflation – far in excess of its mandate. Investors should be happy.

But how much risk are they taking? Stassen points to the fund's performance during the global financial crisis, where its maximum drawdown, as measured by the loss incurred from the highest point to the lowest point, was 8%. This compared with funds in the (general equity) medium equity balanced mandate sector that were seeing average drawdowns of 20%.

Unlike some of their peers in this space, they have taken up just about their full allocation (24,7% of 25% allowable) for offshore investments. And in true Coronation style, they have invested half of this into companies that have substantial pricing power, which allows them to generate returns far in excess of inflation. Companies overseas that have been meeting their criteria include fast-moving consumer goods businesses like Unilever, P&G and Colgate Palmolive. A few technology companies like Microsoft and Cisco have fitted the bill too.

Locally the portfolio has been acquiring the predictable cash flows of companies such as Spar, Tigerbrands and MTN. All in all, equities account for 50% of the portfolio. And true to the genre, Stassen and Groenewald have loaded up on inflation-linked corporate debt, which pays a slightly higher margin over inflation than the government-backed equivalents. **IM**

CADIZ EQUITY LADDER

Performance to end June		
Period	Cumulative return	Rank **
Six months	-0,58%	47
One year	11,44%	10
Three years*	12,08%	5
Five years*	15,32%	1

Fund size (Rm): 1,200
Total expense ratio: 2,16%

*annualised return ** Domestic asset allocation targeted absolute and real return sector

Source: Morningstar

THE CADIZ EQUITY Ladder is a bit of a misnomer in the absolute return category of the Asisa classifications. This is according to fund manager Francois Finlay, who says the fund resembles more of an equity value fund than anything else. The fund is only in the absolute return category because it sometimes holds more cash than is permissible under the Cisca equity regulations.

The recipe for the fund is fairly

straightforward. Finlay constructs the fund using only two asset classes: equities and cash. He then uses derivatives to minimise risk.

The equity component, which invests in the top 40 index, is allowed to range between a maximum of 90% and a minimum of 50% of the fund. It currently accounts for 55% of the portfolio.

For the cash component, Finlay invests with the banks on call and into short-term floating deposits.

The trickier part comes in where Finlay uses listed options to minimise losses that the equity component may incur. What this does is allow the fund to participate in the up- and downside of the market, but it moderates the performance on both sides. When the market moves up the fund moves up but not to the same degree, and vice versa on the downside.

The rationale for using derivatives in such a way is that the performance over time between the fund and the market will diverge, as the equity ladder recovers sooner from market corrections. The results speak for themselves, but beware that the fund may be more volatile than some of its peers in this space. **IM**

LIKE MANY OF its peers, the Prudential Inflation Plus Fund targets a real return – inflation plus 5%. But despite the slightly more aggressive target (most funds target 3%-4%) the fund has volatility similar to that of a bond fund, says fund manager Michael Moyle.

The determination of how much risk (volatility) the fund requires in order to achieve this objective is done through the prism of a strategic benchmark, says Moyle. This serves to act as a template for asset allocation over the long term.

In the medium term (four- to five-year view) the fund looks at valuations across different asset classes to decide which sectors may justify divergences from the strategic benchmark. A case in point: Moyle thinks that offshore equities are attractively priced and so has allocated 16% of the portfolio to offshore equity funds (including to the Prudential global

PRUDENTIAL INFLATION PLUS FUND

Performance to end June		
Period	Cumulative return	Rank **
Six months	4,23%	1
One year	14,45%	5
Three years*	9,10%	12
Five years*	10,36%	5

Fund size (Rm): 4,919

Total expense ratio: 1,52%

*annualised return ** Domestic asset allocation targeted absolute and real return sector

Source: Morningstar

group's funds) that invest on the fund's behalf.

The fund has roughly the same allocation to local equities, and here Moyle points to the fund being overweight in resources, particularly diversified miners, as well as in local banks.

Moyle says he understands the challenges the banks are facing but thinks their valuations are compelling.

The portfolio also has a sizable exposure to listed property, which accounts for 8% of the portfolio. This is an asset that usually enjoys a growing income stream, and Moyle thinks that property yields can grow in real terms over the medium term. **IM**

Funds data supplied by

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