

PORTFOLIO MANAGER COMMENTARY

The fund returned a superb 1.78% for August, this during a turbulent month filled with news of sharp downward equity market moves, an unprecedented ratings downgrade of the mighty AAA-rated USA, European Government bond yields spiking on the back of the ongoing debt crisis and US Treasuries rallying to new lows despite their now more lowly status in the world. We attribute much of this superior monthly return to our high weighting in inflation linked bonds (19%) as well as the fixed rate bond exposure which is in the form of SA longer dated corporate bonds (24%). Some currency weakness during the month also aided this outcome as we increased the fund's offshore exposure on rand strength.

The All Bond Index (ALBI) returned 3.49% in August, just ahead of the inflation-linked index at 3.39%. Both were well ahead of cash, which returned 0.47%. Nominal and inflation-linked bonds have provided similar returns over the past 3 months, but on a year-to-date basis there has been comfortable outperformance by inflation linkers at 9.6% vs the 7.4% of nominal bonds. Cash has lagged far behind, returning just 3.8%.

Globally, August was (again) dominated by debt crises and a raft of weak data. The month began with a generally anticipated downgrade of US sovereign debt by Standard and Poor's, to AA+ (the other two main ratings agencies, Moody's and Fitch, left the US at AAA). This watershed moment resulted in a surprising outcome, the US Treasury producing the best return out of US stocks and commodities during August as it traded from 2.81% to close the month at 2.2%. However, this was probably less explained by the downgrade than by continuing concerns over both US and global growth, coupled with continuing concerns on the European debt front.

With regards to Europe, the debt situation remains extremely murky. Italian and Spanish rates spiked in early August, leading to ECB buying of their bonds. Both countries announced new austerity measures, but at the time of writing Italy seemed to backpedalling on its promises, to the chagrin of the ECB. Meanwhile, Greece seems unable to extract itself from the mire, with latest news being that the Budget deficit for this year is expected to be around 1% greater than the 7.6% agreed with the EU/IMF. Greek bond yields continue to trade around all-time highs. It is clear that the European situation remains far from resolved, and while ECB bond buying has helped calm the markets somewhat, the fundamental issues have yet to be addressed properly. We do not think that we will be out of the woods here for a long time.

US bonds and the Euro peripheral fears continued to support 'core' bond markets globally as well as tended to influence emerging market bonds, including those in South Africa. Thus, despite the continued upward trend in inflation, SA bonds have managed to continue gaining. The SARB's inaction on the repo rate – where it is clearly giving a far greater weight to both domestic and global growth concerns at the moment – has also helped support the market. Most analysts have pushed out their forecasts of the beginning of the rate hike cycle – not because they are more positive on inflation, but because of the MPC's greater weight given to growth concerns at present.

More recently, the market seems to have become increasingly convinced of a rate cut in South Africa. While we would not rule this out, we think the hurdle is rather high, given SA inflation. We think we would need to see very weak global growth (possibly, weak enough to see the ECB reverse its rate hikes of earlier this year) for the SARB to cut. As it is, the real repo rate in SA is roughly zero at present and negative on a forward-looking basis, meaning the current policy stance is still very accommodative.

The situation continues to strike us a rather tenuous one for South Africa. Low interest rates and risk aversion globally are supporting SA bonds at present. However, we remain concerned that should Euro concerns blow up rather than blow over, risk aversion would intensify and the rand may well be a casualty of this. We are also concerned that the SARB's inaction on rates will lead to inflation expectations to be at the upper end or above the 3 – 6% target range for a protracted period of time.

The fund has a good size holding in inflation linked bonds which have performed well as real rates contracted and inflation has edged higher. Even if valuations are looking full in this asset class, we view these as still offering an important inflation hedge.

The fund continues to hold floating rate bonds which currently yield around 6.5% – 7.5% and act as a useful hedge against sharp interest rate hikes. Even if interest rate hikes are not expected any time soon, experience has shown that the market has the potential to price an upward move in interest rates very quickly and these instruments protect the fund from price volatility in this scenario. In a similar vein, we have started to roll fixed rate bond exposure into floating rates via the swaps market thereby locking in the capital gains achieved thus far and converting the cash flow profile into one of a floating rate investment.

Property stocks performed well during this month as a now lower interest rate outlook supported this sector. Listed property achieved good distribution growth with some counters achieving more than 8% for the 6 month period. The best performers were those with more industrial and minimum office exposure, which is where vacancies are at their worst.

Preference shares have had a poor month with returns flat for the period. During August Discovery Holdings Ltd issued its first perpetual preference share at a yield of 85% of prime which equates to 7.65%. We were keen participants in this issue given its attractive pricing and the quality name. With money market rates dwindling, preference shares are looking relatively attractive with clean dividend yields ranging from 7% - 7.5%.

The portfolio continues to be conservatively managed with the view of providing investors with a return which exceeds cash over time, without having to take undue risk to achieve this. Opportunities in this low interest rate environment are less forthcoming; however, we continue to seek out the best relative value across the fixed interest space for our investors.

Portfolio managers

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