Volume 10, No. 06,
June 2014

Benchmark Retirement Fund

MONTHLY REVIEW OF PORTFOLIO PERFORMANCE TO 30 JUNE 2014

By T H Friedrich – Managing Director, Retirement Fund Solutions Namibia (Pty) Ltd

The monthly review of portfolio performance, as set out in this issue, is also available on our website at www.rfsol.com.na.

1. Review of Portfolio Performance

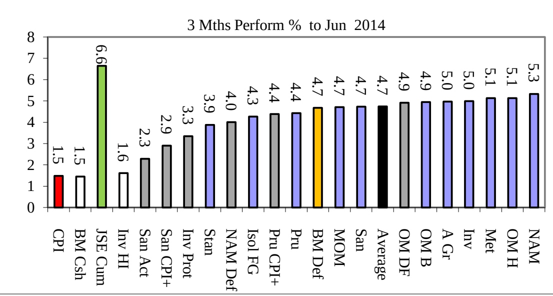
In **June** the **average prudential balanced portfolio** returned 1.81% (May: 1.52%). Top performer is Metropolitan (2.52%); Investment Solutions (1.49%) takes the bottom spot. For the 3 month period Namibia Asset Management is top performer outperforming the 'average' by roughly 0.6%. On the other end of the scale Stanlib underperformed the 'average' by 0.8%.

Graphs 1.1 to 1.7 reflect the performance for periods from 3 months to 10 years of a number of the most prominent prudential balanced portfolios (blue bars), 'special mandate portfolios' with lower volatility risk (grey bars), fixed interest portfolios (no color bars), the average of prudential balanced portfolios (black bar), the JSE Allshare Index (green bar), and the CPI (red bar). Benchmark investors should take note of the performance of the default portfolio (yellow bar), which now represents a combination of Prudential Namibia Inflation Plus and Allan Gray Namibia Balanced Fund.

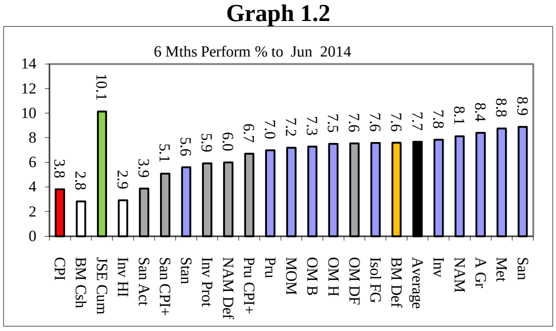
Below is the legend to the abbreviations reflected on the graphs:

Benchmarks	
Namibian Consumer Price Index	CPI (red)
JSE Allshare Index	JSE Cum (green)
Benchmark Default Portfolio	BM Def (yellow)
Average Portfolio (prudential, balanced)	Average (black)
Special Mandate Portfolios	
Money market	BM Csh (no color)
Investec High Income (interest bearing assets)	Inv HI (no color)
Investec Protector	Inv Prot (grey)
Prudential Inflation Plus	Pru CPI+ (grey)
Old Mutual Dynamic Floor	OM DF (grey)
Sanlam Active	San Act (grey)
Sanlam Inflation Linked	San CPI+ (grey)
NAM Coronation Balanced Def	NAM Def (grey)
Market related portfolios	
Allan Gray Balanced	A Gr (blue)
Investec Managed	Inv (blue)
Investment Solutions Bal Growth, (multimanager)	Isol FG (blue)
Prudential Managed	Pru (blue)
Metropolitan Managed	Met (blue)
NAM Prudential Balanced	NAM (blue)
Old Mutual Profile Balanced	OM B (blue)
Old Mutual Profile Growth	OM H (blue)
Momentum Managed	MOM (blue)
Sanlam Balanced	San (blue)
Stanlib Managed	Stan (blue)

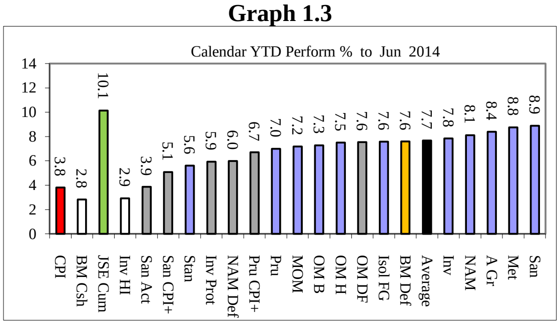
Graph 1.1



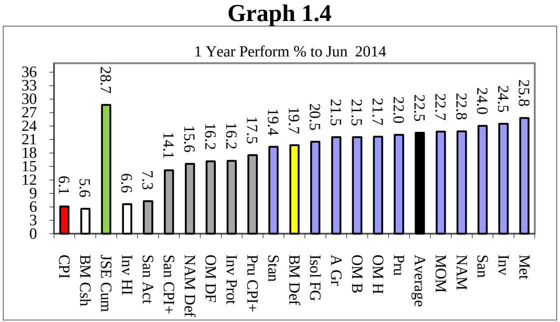
Graph 1.2



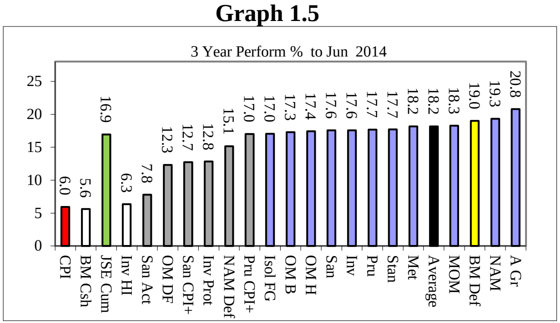
Graph 1.3



Graph 1.4



Graph 1.5



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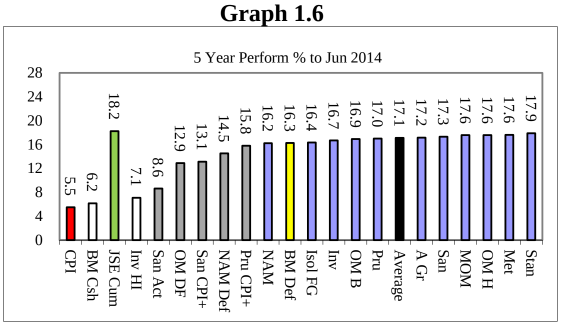
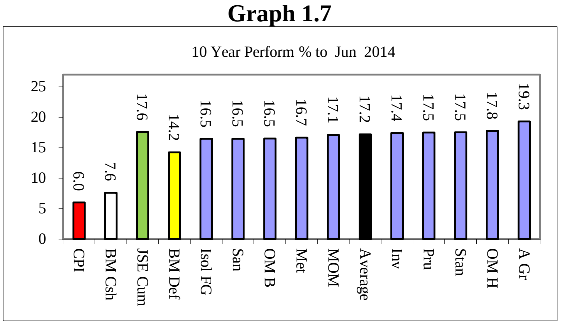
Graph 1.6

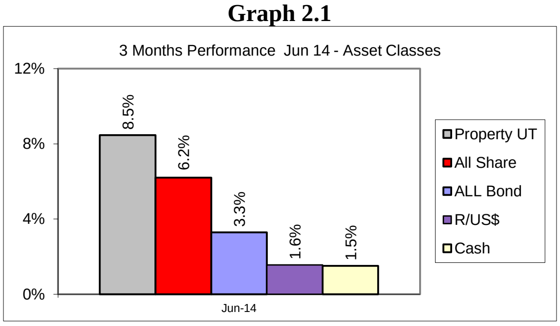


Graph 1.7

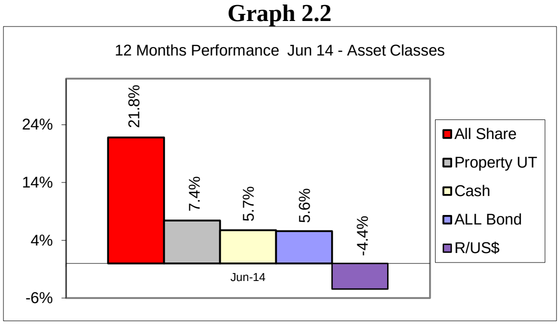


2. Performance of Key Indices (index performance by courtesy of IJG/Deutsche Securities)

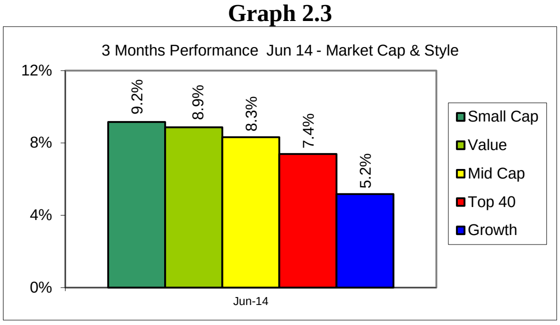
Graph 2.1



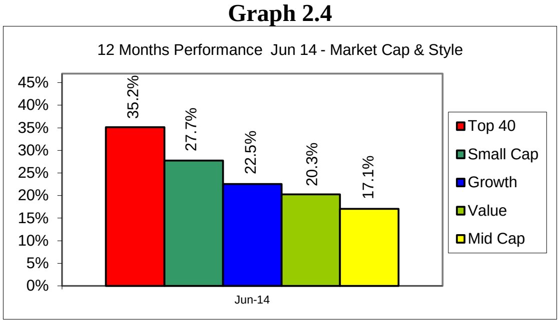
Graph 2.2



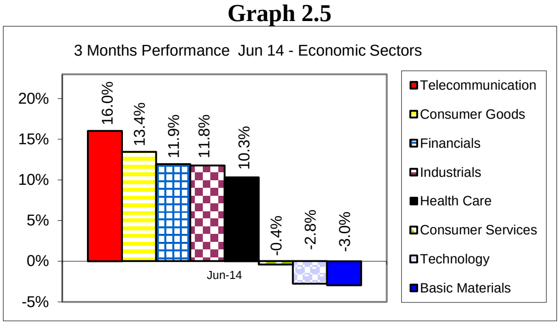
Graph 2.3



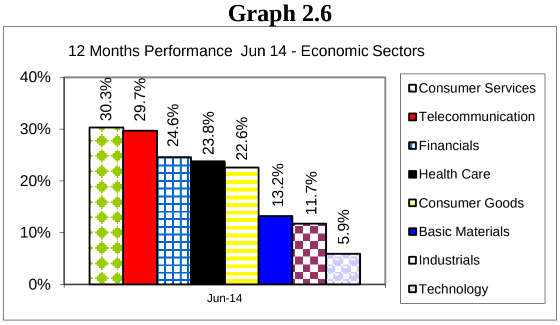
Graph 2.4



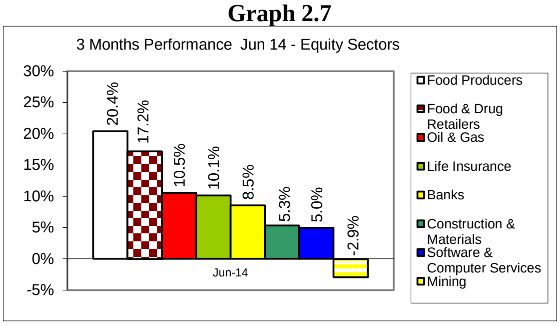
Graph 2.5



Graph 2.6



Graph 2.7



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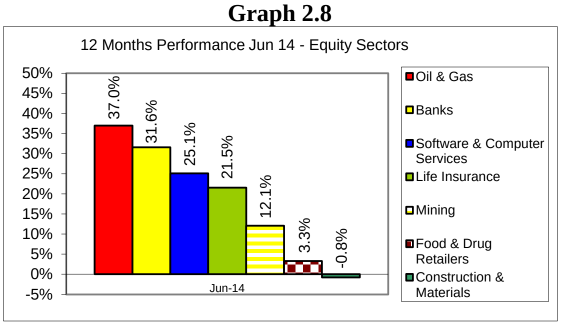
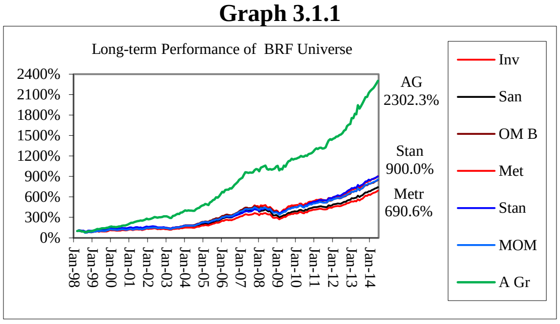
Graph 2.8



3. Portfolio Performance Analysis

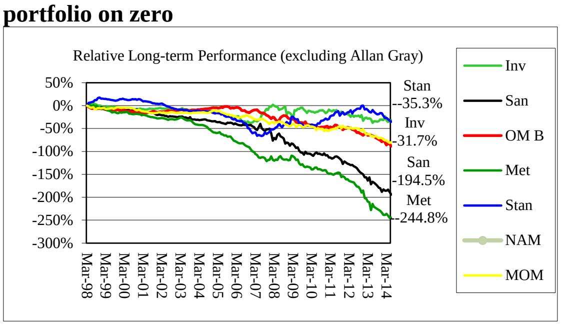
3.1. Cumulative performance of prudential balanced portfolios

Graph 3.1.1

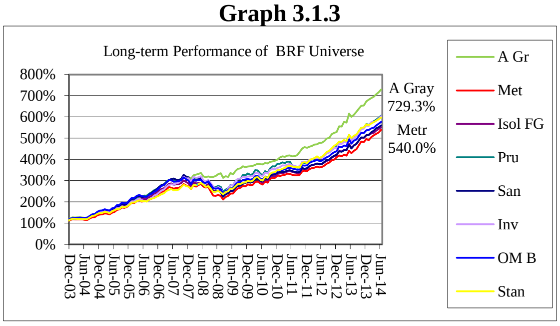


Graph 3.1.2

Cumulative performance of prudential balanced portfolios relative to average prudential balanced portfolio on zero

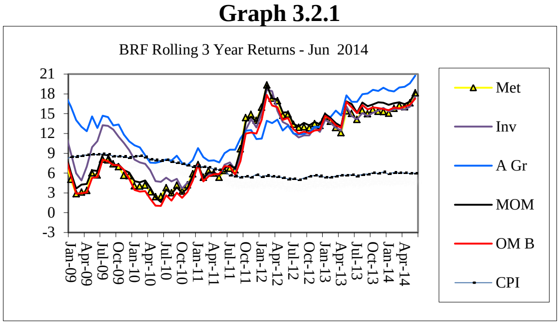


Graph 3.1.3

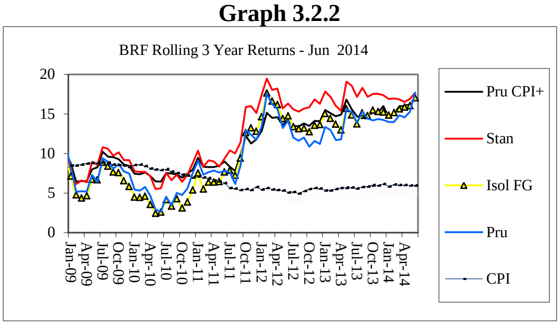


3.2. 3-year rolling performance of prudential balanced portfolios relative to CPI

Graph 3.2.1

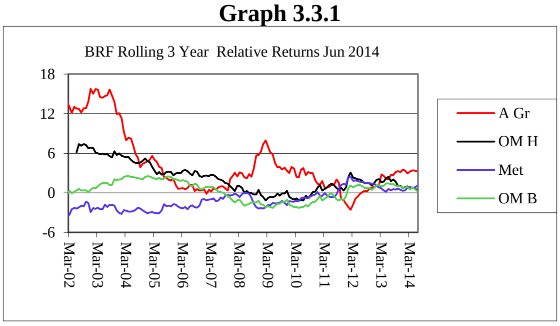


Graph 3.2.2

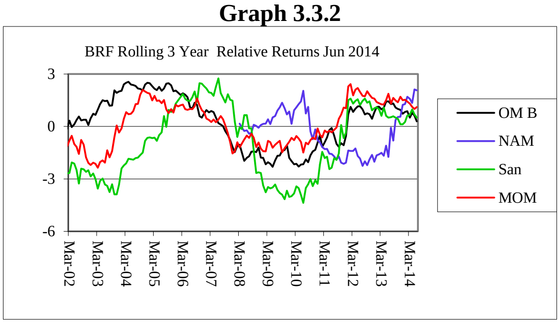


3.3. 3-year rolling performance of prudential balanced portfolios relative to average prudential balanced portfolio on zero

Graph 3.3.1



Graph 3.3.2



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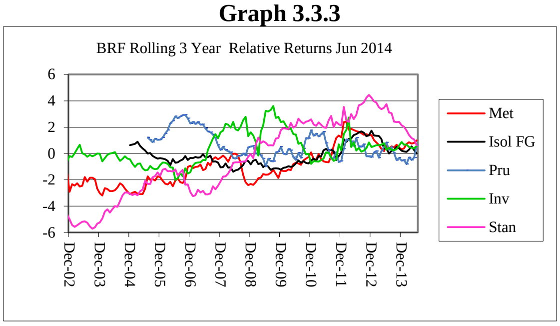
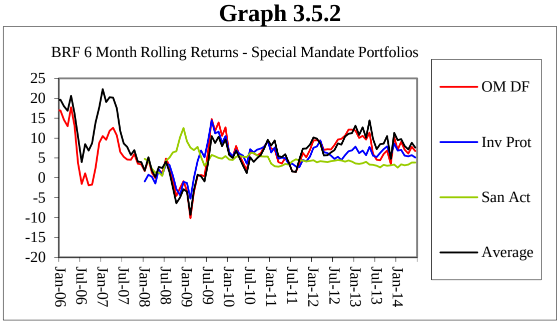
Graph 3.3.3

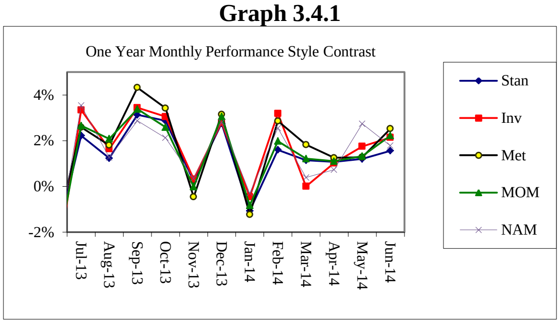


Graph 3.5.2

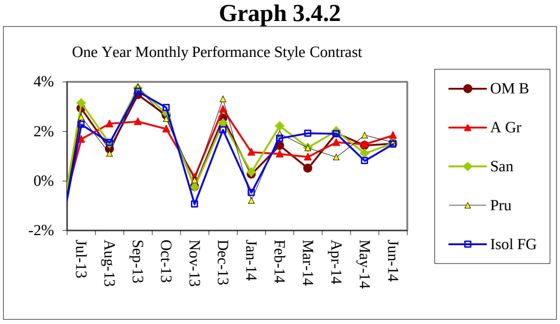


3.4. Monthly performance of prudential balanced portfolios

Graph 3.4.1

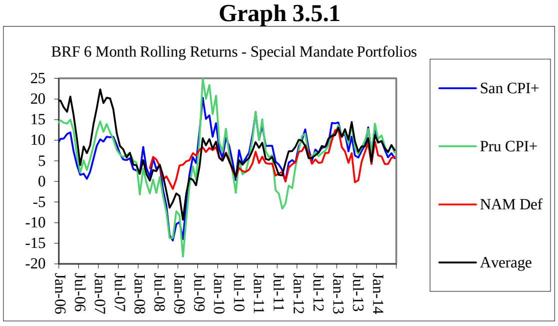


Graph 3.4.2



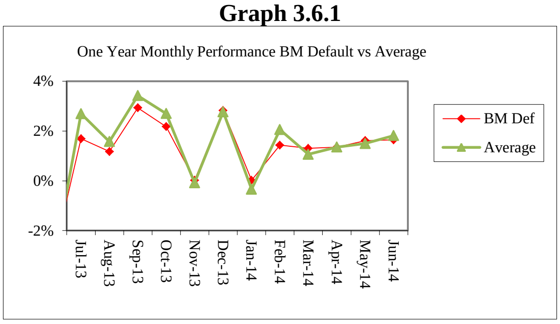
3.5. 6-month rolling returns of 'special mandate' portfolios

Graph 3.5.1

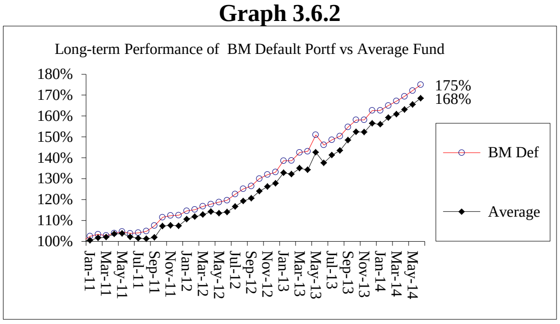


3.6 Monthly and cumulative performance of 'Benchmark Default' portfolio relative to average prudential balanced portfolio

Graph 3.6.1

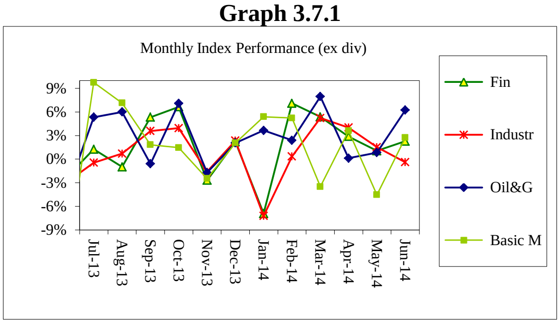


Graph 3.6.2



3.7 One year monthly performance of key indices (excluding dividends)

Graph 3.7.1



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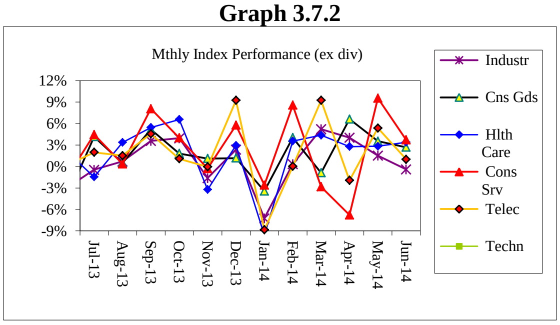
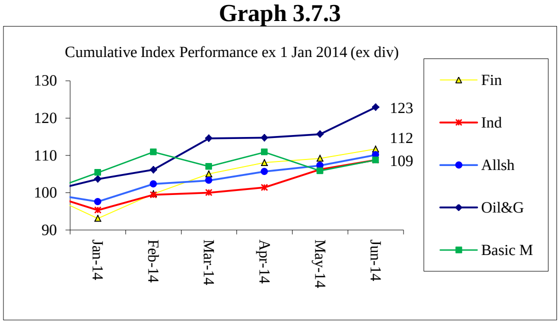
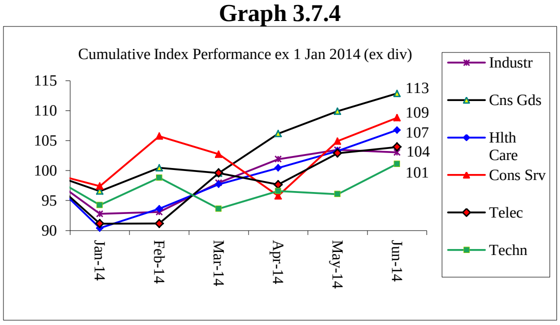
Graph 3.7.2



Graph 3.7.3



Graph 3.7.4



4. The Benchmark Default Portfolio

Graph 1.6 shows that the average prudential balanced portfolio returned 17.1% p.a. in nominal terms, or 11.6% p.a. in real terms, over the past 5 years while the Benchmark Default portfolio returned 16.3% p.a. in nominal terms, or 10.8% p.a. in real terms. The Benchmark Default portfolio is designed to produce a less volatile performance but also lower returns than the average prudential balanced portfolios with its significantly lower equity exposure (48.9% vs. 60.5% of the average prudential balanced portfolio, as at the end of March 2014) and the lower risk it consequently entails for the investor. It should be expected to underperform the average prudential balanced portfolio at times when shares outperform other asset classes and vice versa.

Considering that the average prudential balanced portfolio should deliver a real return before management fees (typically 0.75%), of roughly 6% per year, these portfolios are currently exceeding the expected long-term goal significantly over the past 5 years.

Having raised the risk profile of the Default portfolio effective the start of 2011, by replacing Metropolitan ARF with the Allan Gray Namibia Unit Trust, we would in the long-term expect the Default portfolio to sacrifice around 1% return for the benefit of lower volatility compared to the average prudential balanced portfolio, thus an expected real return before management fees (typically 0.75%), of around 5% per year. Over the past 5 years this performance objective was exceeded noticeably. Since this change was effected, the default portfolio returned a cumulative 56.7% compared to 53.1% for the average prudential balanced portfolio over this 42 month period.

Relative to the default portfolio, the performance of the prudential balanced portfolios should be more volatile due to a significantly higher equity exposure and its performance should be much closer correlated to that of the overall equity market. The default portfolio should produce a significantly more volatile performance than the money market portfolio. The table below presents one year performance statistics over the 3 years July 2011 to June 2014:

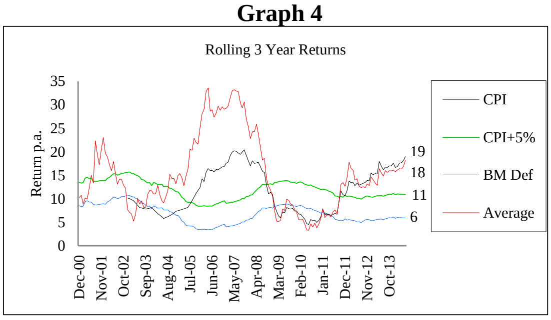
Table 4.1

Measure	Money Market	Default Portf	Average Prud Bal
Worst annual performance	5.3%	9.9%	6.1%
Best annual performance	6.3%	27.1 %	25.6 %
No of negative 1 year periods	n/a	0	0
Average of negative 1 year periods	n/a	n/a	n/a
Average of positive 1 year periods	5.7%	17.3%	16.3%

The Benchmark Default portfolio is a more conservative investment portfolio aimed at reducing negative returns and with a long-term return objective of inflation plus 5% before fees and roughly 4.3% after fees.

At this rate of return, the net contribution towards retirement by both, member and employer should be roughly 13% of remuneration, in order to achieve a reasonable income replacement ratio of 2% per year of service. It is very important that employers invested in the default portfolio are comfortable with these investment characteristics and that they should be able to create comfort amongst their employees as well.

Graph 4



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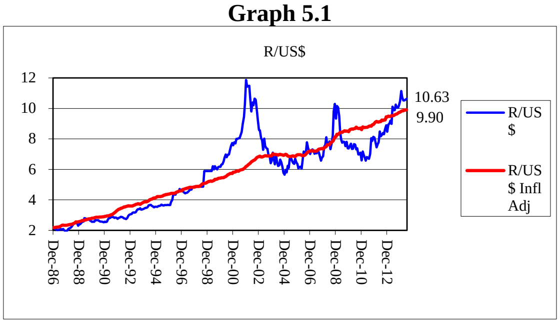
Graph 4 measures the success of the Benchmark Default portfolio in achieving its long-term gross investment return objective of inflation plus 5%, on a rolling 3 year basis. It also shows rolling 3 year returns of the average prudential balanced portfolio and rolling 3 year CPI. It shows that since September 2008, both the Benchmark Default portfolio as well as the average prudential balanced portfolio were lagging inflation plus 5% and have surpassed inflation plus 5% since October 2011, Benchmark default portfolio currently on 19.0%, the average on 18.2% vs CPI plus 5% currently on 11.0%.

5. Review of Foreign Portfolio Flows and the Rand

How is the Rand doing?

Graph 5.1 indicates that the Rand by our measure is fairly valued at 9.90 to the US Dollar while it actually stood at 10.63 at the end of June. Our measure is based on adjusting the two currencies by the respective domestic inflation rates.

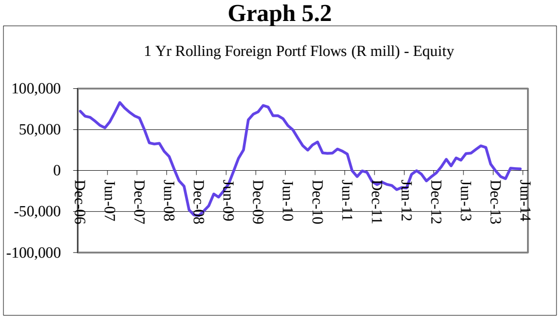
Graph 5.1



Rand strengthens despite foreign capital outflows

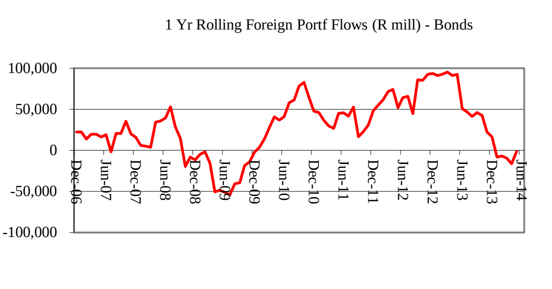
Graph 5.2 reflects a negative flow of capital into South African equities on a rolling one year basis, with a net outflow of R 6.2 bn on a year-on-year basis at the end of June (inflow of R 2.2 bn to end May). Since the beginning of 2006, foreign net investment in equities amounts to R 185 bn (end May R 186 bn). This represents roughly 1.6% of the market capitalization of the JSE.

Graph 5.2



Graph 5.3 on a rolling one year basis reflects foreign portfolio outflows in respect of SA bonds of R 0.9 bn over the past 12 months to end of June (outflow of R 1.2 bn over the 12 months to end of May). Since the beginning of 2006, foreign net investment in bonds amounts to just over R 216 bn (to May just over R 238 bn).

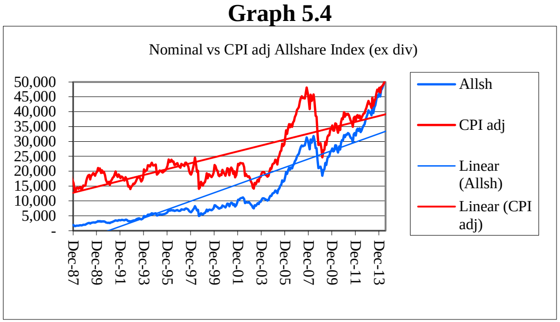
Graph 5.3



The net outflows of foreign capital from equity and fixed interest assets was R 7.2 bn for the 12 months to end June 2014 (inflow of R 1.0 bn to end May 2014), compared to R 71.6 bn for the 12 months to end June 2013 (R 105.2 bn to end of May 2013). Since the beginning of 2006, total net foreign portfolio flows amounted to R 402 bn (May R 424 bn).

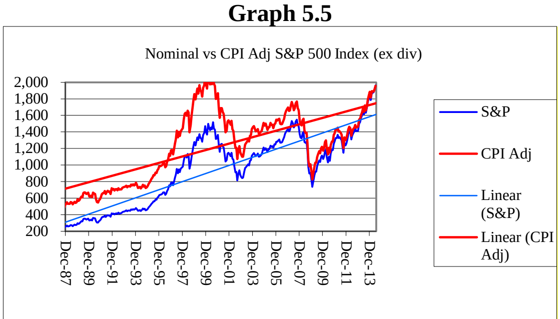
Graphs 5.4 reflects the movement of the JSE since January 1987 in nominal terms, adjusted for indigenous inflation, with trend lines for these. In nominal terms, the JSE grew by 12.5% per year since January 1987, and this excludes dividends of somewhere in the region of 2% to 4%. Namibian inflation over this period was 8.6% per year. This is equivalent to a growth in real terms of 3.6% p.a. over this period.

Graph 5.4



Graph 5.5 reflects the movement of the S&P500 Index since January 1987 in nominal terms, adjusted for indigenous inflation, with trend lines for these. Since January 1987 the S&P500 Index has grown by 7.4% per, over this period of 27 years. US inflation over this period was 2.8%. This is equivalent to a growth in real terms of 4.5% p.a. over this period.

Graph 5.5



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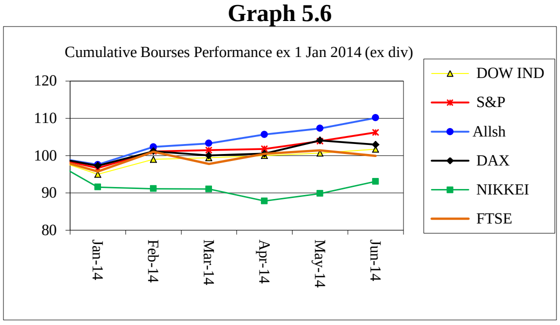
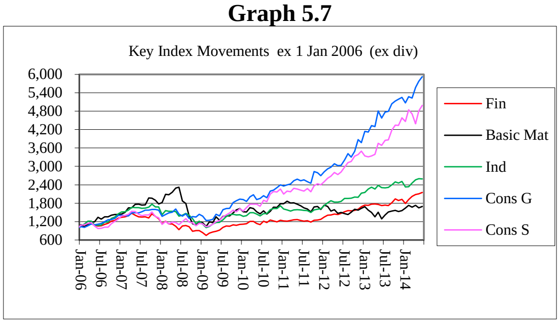
Graph 5.6 provides an interesting overview of some of the major global share indices, showing up the Allshare and the S&P 500 as the top performing share indices.

Graph 5.6



Graph 5.7 provides an interesting overview of relative movement of the key equity sectors on the FTSE/JSE since December 2005 when these indices were first introduced. From this the investor should be able to deduce which sectors offer greater value and which one's offer less value on the basis of fundamentals. Annualised returns for these indices since the beginning of 2006 were: Consumer Goods: 23.3%; Consumer Services: 20.8%; Industrials: 11.8%; Financials: 9.4% and Basic Materials: 6.4%.

Graph 5.7



6. Conclusion

Over most periods depicted in the performance graphs 1.1 to 1.7, equities outperformed the best performing prudential balanced portfolio. Adding in dividends of somewhere between 2% and 4%, equities have in fact outperformed over all periods. Barring a few exceptions these graphs also show that high equity portfolios (blue bars) have outperformed low equity portfolios (grey bars) as the result of equities having outperformed the other lower risk asset classes such as property, bonds and cash.

Graph 5.4 shows that equities have passed their peak at the end of 2007 in real terms, much more so in nominal terms. They are now significantly above the trend line of the index since the beginning of 1988 which represents a normalised commencement date and covers a period of 26 ½ years. This graph also shows that the index has been pausing below the trend line regularly.

The investor should in the first instance be wary of investing when the market is above the trend line as it currently evidently is. It is thus not the right time to increase one's equity exposure to the local equity market now but to rather wait for the market to retract. What about foreign markets though? Graph 5.5 paints a surprisingly similar picture of the US S&P 500, also indicating that it is at first sight not the right time now to increase one's exposure to US equities.

A further consideration is whether the trend line is representative of a fair growth rate of companies represented by the index. The JSE Allshare Index trend line represents an annual real growth of roughly 4% per annum, while the trend line of the S&P 500 represents an annual real growth of around 3%.

Assuming that the respective indices are not distorted by factors such as significant changes in the composition of the index, or a significant divergence between a small number of large companies and a large number of small companies, we would argue that in both cases the trend line fairly represents the growth that can be expected to be delivered by the companies measured by these indices.

In the article 'Is the JSE really too high?' in Moneyweb of 23 July (follow this link), Patrick Cairns concludes that the local index represents a 'two-tiered' market where the average price: earnings ratio of the top 10 shares is 25.6 while the average of the bottom 10 shares is only 13.6. The market as a whole is thus expensive but this is distorted significantly by the top 10 shares on the JSE. In other words, if one looks further than the top 10 shares the conclusion of local shares being expensive, does not necessarily apply to all shares and that there are many shares that present buying opportunities.

Although we would not expect the S&P 500 to be subject to similarly significant distortion, buying opportunities no doubt exist in the US as well. The crux of this argument is that stock picking skills are a key attribute to successful investment in equities the equity investor should look out for under current market conditions.

Having concluded that the local and the US equity markets are on average expensive, without an unexpected shock to the financial system, we would not expect a major downward adjustment but rather an extended flat performance, once central bank intervention in financial markets ends. Until then, equity market should still experience some tail winds. At this stage an end of the monetary stimulus measures, other than in the US, is not foreseen for another year.

As far as the other asset classes are concerned, cash currently returns a negative real interest rate. Bonds are sensitive to interest rate movement and these movements are most likely to be upwards and highly unlikely to be downwards. As the result bonds are currently not an attractive asset class and will remain unattractive until interest rate levels have normalized. This is also not foreseen for the next few years.

Generally, global financial markets are due to move into the doldrums over the next year or two and will languish for an extended period until excess liquidity has been removed from the global financial system.

Under these circumstances, we consider equities the preferred asset class and would maximise exposure to equities for the foreseeable future. Since the local equity market on average is expensive, international diversification into markets with superior growth prospects should be maximised. These are countries that were worst hit by the financial crisis and have not recovered yet as well as emerging economies. As we suggest above, stock picking skills are critical to investment in equities. A 'safe play' of investing in companies with superior free cash flows, high dividend yields and low p:e's in industries that focus on basic consumer needs and perhaps in new technologies is what we would be looking for.

7. Important notice and disclaimer

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