PRESCIENT

INCOME FUNDS DISPEL THE NOTION THAT RISK AND RETURN ARE OPPOSITES

They can and do outperform other asset classes.

Marcia Klein

Investors in income funds typically buy them to draw income and have two requirements: they want stability in capital values, and they want real returns.

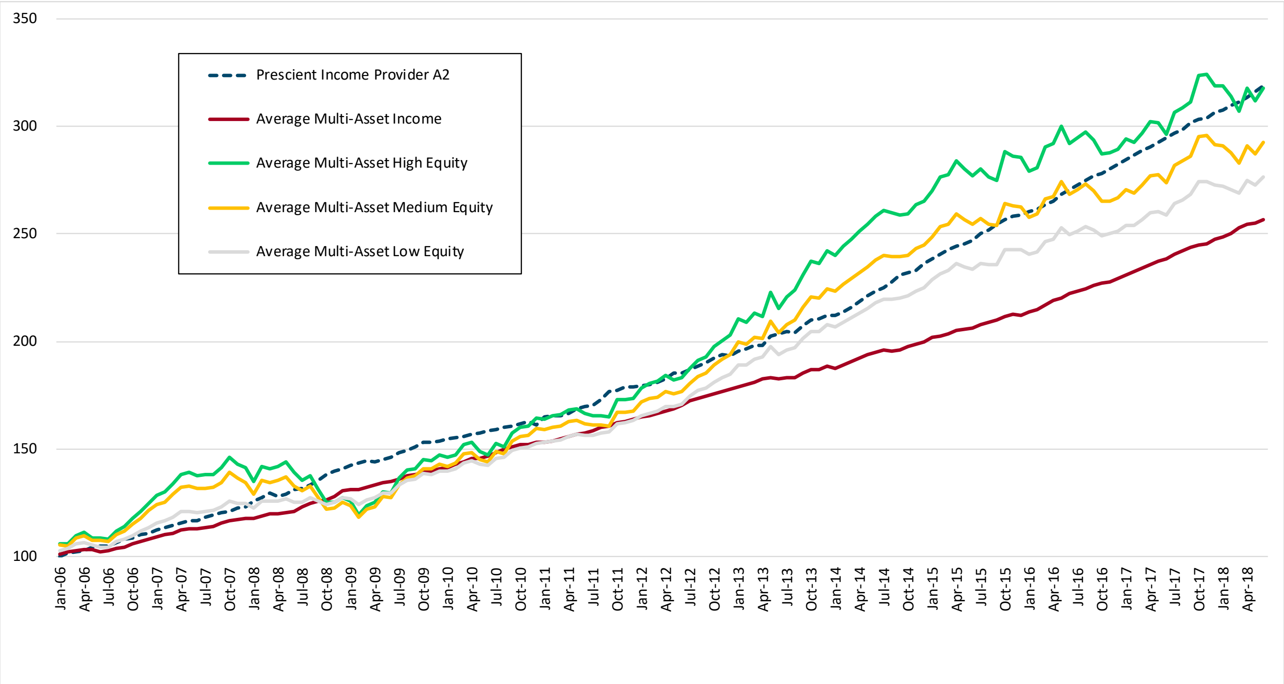
Prescient Management Company CEO Meyer Coetzee says income funds are suitable for investors seeking stable real returns and aiming to maximise income via exposure to money and bond markets.

What investors may not expect, however, is that one of those income funds, the Prescient Income Provider Fund, has outperformed more than half of all balanced unit trust funds over the last 12 plus years since the Fund was launched, at a fraction of their volatility.

“Conventional wisdom tells one that risk and return are the two opposites, but our Income Provider Fund has delivered consistently above inflation every year since inception in December 2005, and over the whole period, it has returned 3.5% [in real terms] after fees,” he says.

“Over the last 12 plus years, since the Fund’s inception, it has never lost capital over any three-month rolling period.”

“If you compare other alternatives available for retirees, specifically across the ASISA Multi-Asset categories, which are the “balanced funds”, it has outperformed the average of all in a stable progression.”



PRESCIENT INVESTMENT MANAGEMENT (PTY) LTD

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Source: Morningstar (as at June 30, 2018)

“Currently the gross yield of Income Provider is 9%, and inflation 4.9%, so the yield is just over 4% above inflation,” Coetzee says. “Looking forward, the Fund will continue trying to preserve this real yield and therefore continue to deliver returns above inflation.”

While income funds have limited exposure to equities, which have been volatile and have caused some nervousness for investors, they have exposure to other risks.

Coetzee says Prescient is acutely aware of risk factors in a portfolio exposed to inflation and interest rate fluctuations.

The ultimate risk is that the real yield offered to investors decreases. For this to happen either overall yields (or interest rates) must come down or inflation must go up, or combinations of those that would result in the gap between the two to decrease. Due to the positioning of South Africa vs other emerging market peers and the need for the country to remain an attractive investment destination to foreigners, Prescient – and most experts – does not believe that there is much room for yields to drop, especially with interest rates on the increase in most developed economies.

“We do however see interest rates going up, which will benefit our investors as we invest in money market investments of short duration that offer high returns and that will benefit from increasing interest rates.”

The bigger risk is inflation. “If inflation goes down, although that is unlikely, the real return offered by the Fund will increase,” he says. That is good for investors. “But of all the potential scenarios, the big risk is inflation going up.”

To protect investors against that scenario, the Fund uses three distinct strategies.

The first protects against the rand weakening, which will increase the price of all imported goods and result in higher import inflation. Traditionally, protection against rand weakness is achieved by holding foreign currency denominated assets, but because the Fund has a strict risk target of not losing capital over rolling three-month periods, all offshore assets are hedged back to the local currency to remove the risk associated with currency volatility. However, because the impact of currency volatility is hedged, Prescient implemented a zero-cost structure to capitalise on rand weakness and enhance returns should the rand lose value relative to our trading partners, without giving up returns emanating from rand strength. The second strategy utilises explicit inflation protection instruments where the Fund will be compensated should inflation run away. The third, through a five-year instrument, protects the Fund more broadly against the possibility of a major emerging market sell-off, which would lead to imported inflation.

“The beauty of all of these strategies is that the total cost is known and already capitalised, so the Fund and its investors will not face any unforeseen costs,” Coetzee says.

“We can therefore say with a great level of certainty that over the foreseeable future, the Fund will continue to deliver attractive real returns, experience low capital volatility and give our investors peace of mind.”

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