QUARTERLY COMMENTARY

JULY 2024

Prescient on point.

Prescient

INVESTMENT MANAGEMENT

In this issue

Debunking the notion that global managers are better

A NOTE FROM OUR CEO

by CHEREE DYERS
Chief Executive Officer

Advances in investment strategies, like systematic investing, mean it no longer matters where an investment manager is situated.

Systematic investing has enabled investment managers to compete on the global stage from anywhere, debunking the notion that you need an international presence to be a successful global investor.

Yet, ASISA data shows that between March 2023 and March 2024, asset allocators and investors withdrew a net R27.9 billion from locally registered foreign collective investment schemes. This counters the increasing appetite for investing offshore to take advantage of the 45% offshore ceiling as a percentage of total assets regulators put in place year on Regulation 28 Funds.

One explanation for this counterintuitive outflow of funds is that South African asset allocators are withdrawing from locally registered funds and putting them into global funds that are perceived to have the advantage of being managed by an investment company with an international presence.

If that is the case, it could prove a short-sighted decision because advances in investment strategies, like systematic investing, mean it no longer matters where an investment manager is situated. South African fund managers with world-class systematic investment businesses, like Prescient, are just as well positioned as their global counterparts to deliver global investment performance that is up there with the best.

Why?

Traditionally, investors have considered two options when investing globally: passive, index-linked funds that offer market-related performance and actively managed funds that generate alpha through stock picking. In the latter case, performance depends on picking the best stocks, which necessitates doing a detailed analysis of hundreds, if not thousands, of companies worldwide; ideally, visiting as many as possible to assess their management teams and growth potential.

Systematic investment strategies offer a unique middle ground—the best of both worlds. They deliver alpha (returns above the market) and are notably more cost-effective. Due to their lower operational overheads, they are cheaper than traditional active managers, making them a compelling choice for the financially savvy investor.

The success of their investment approach lies in having access to the right type and sufficient volumes of global economic and financial market data, which informs a rules-based, rational, agile, and repeatable investment process. This enables fund managers to see through the noise, formulate a forward-looking view of the markets and asset classes based on the insights generated by the data, and build robust portfolios.

The foundation of Prescient's systematic investment process is its proprietary data analytics platform, which accesses more than 500 million data points, 100 000 time series and 10 000 financial instruments in real time, giving us an always-on view of economic and financial market developments.

> Our systematic investment process takes advantage of the quality insights we derive from this data to make timeous, systematic and well-founded investment decisions based on macroeconomic and financial conditions anywhere in the world at any point in time.

Thus, we don't need to be on the ground where our investment decisions are being made. Instead, we have the advantage of investing with clarity, rationality and foresight based on our comprehensive global data sets and rigorous, tried and tested systematic investment process.

Seeing through the volatility and focusing on what is important

A LOOKBACK ON THE PAST QUARTER

by BASTIAN TEICHGREEBER
Chief Investment Officer

> "The ability to focus attention on important things is a defining characteristic of intelligence."
>
> – Robert J. Shiller

The global macroeconomic landscape and capital markets have displayed pronounced volatility over the past quarter, highlighting the benefits of being methodical and adopting an evidence-based investment approach to see through the noise. This is in harmony with US economist Robert J. Shiller's assertion, "The ability to focus attention on important things is a defining characteristic of intelligence." In the investment realm, this type of intelligence is crucial for distinguishing between substantive, empirically supported, systematic indicators and ephemeral market noise.

The persistent inflationary pressures are still significantly shaping global macroeconomic conditions and capital markets despite some data suggesting a moderation in inflation rates. For instance, CPI data in the US showed consumer inflation increased 3.3% over the last quarter. Although this figure was lower than anticipated, it still surpassed the target rates set by central banks, leading to market adjustments, including expectations for two rate cuts by the Federal Reserve within the year.

> The volatility of the global bond markets further underscores the inflation experience, with the U.S. 10-year Treasury note yields varying between 4.2% and 4.7% during the quarter. These fluctuations reflect the market's continuous recalibration of risk assessments concerning future inflation and interest rate movements.

Equity markets have been resilient amid these uncertainties. The S&P 500 Index increased about 4% over the quarter, buoyed by the prospect of more accommodating financial conditions and strong corporate earnings, which have helped mitigate concerns over rising borrowing costs and a potential economic slowdown.

South African Capital Markets

In South Africa, local and global economic dynamics influenced the capital markets. The global inflation trend was generally positive, although domestic issues, such as currency volatility and political instability, were particularly significant in the lead-up to and after the national election. Despite these challenges, the local All Share Index navigated these conditions effectively, posting a 7% gain over the quarter and outperforming many major global indices.

The South African rand's appreciation against major currencies has also provided a critical gauge of investor sentiment, reflecting optimism concerning the nation's political environment and broader global economic trends.

The Importance of a Systematic Investment Approach

Navigating such a complex investment landscape requires investors to maintain a disciplined focus on long-term economic fundamentals rather than reacting impulsively to headline-driven volatility. Shiller's emphasis on the importance of focusing on significant matters is especially pertinent in today's volatile market environment, where a systematic investment strategy underpinned by quantitative data and rigorous analysis is indispensable. This approach enables investors to uncover real value opportunities and understand underlying risk factors that may not be immediately apparent from cursory market observations.

Our systematic strategy involves the econometric modelling of relationships between interest rates, inflation, and asset prices. This provides a structured framework for understanding market dynamics beyond the immediate fluctuations typical of trading sessions. By concentrating on these foundational relationships, investors can better anticipate long-term trends and make informed decisions based on underlying market conditions rather than speculative headlines.

In conclusion, the recent developments in both global and South African capital markets underscore the imperative for an analytical, evidence-based approach to investment. Echoing Shiller's insights, intelligent investment necessitates focusing on significant, long-term market drivers, ensuring that decisions are founded on solid economic principles rather than transient trends. This methodical approach is essential for effectively navigating the complexities and uncertainties of today's financial landscapes.

Hedging your bets on the rand

by RUPERT HARE
Head of Multi-Asset

and SHRIYA ROY
Quantitative Analyst

What if we could remove the variability in the currency but keep the gains from rand depreciation? The good news is that it *is* possible.

The rand-dollar exchange rate has been on a rollercoaster ride, with the rand gaining over 3% the month after the South African elections. Who could have predicted that outcome with 100% certainty before the election period?

Some investment managers shifted towards safer, dollar-based offshore assets during this period to protect against the tail event of another rand blowout. But is this always a good idea?

> The short answer is no. Investing offshore and currency risk go hand in hand. When you invest in a foreign asset, such as US equities, your dollars-based returns will eventually need to be converted back to rands. That conversion happens every day for a rand-based fund since the offshore asset is priced in rands.

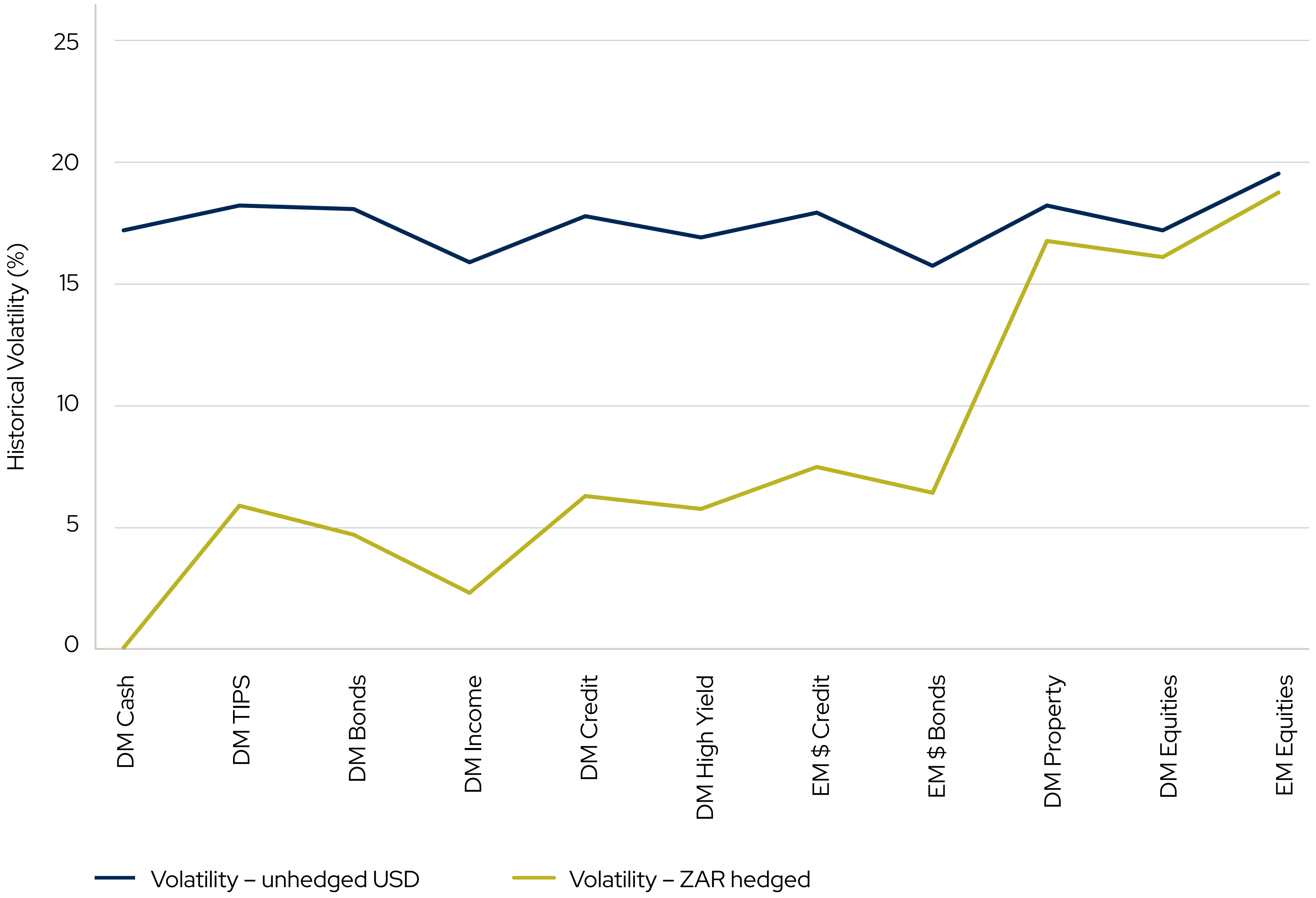
One thing we know about the rand is that it is highly volatile, so there is a chance that the exchange rate won't work in your favour as an SA investor. Consider a hypothetical trade as an example – you have a great thesis on a US stock, so you convert rands to dollars, buy the stock and sit back and wait. Your thesis plays out, and you make 10% on the stock, so you sell and convert the proceeds back into rands. But, in the interim, the rand has strengthened 20% versus the dollar. The net result is you lose around 10% on the trade; your call on the stock was correct, but it was overshadowed by moves in the rand.

Getting the currency right bolsters your return, but the problem is that currency moves are unpredictable and driven by many factors. What if we could remove the variability in the currency but keep the gains from rand depreciation? The good news is that it *is* possible, and the way to do that is by hedging out a portion of your currency risk. We do this to varying degrees in our Multi Asset Funds. In this way, you are not giving up any performance on the portfolio, and you are smoothing your performance by reducing overall risk.

In the past month, when the rand strengthened, we partially hedged out this effect on our offshore performance. We did this by using derivative contracts to effectively lock in the long-term interest rate differential of around 4% (what the rand is expected to depreciate by in the long term) and eliminate any unpredictable movements in the exchange rate. A currency-hedged exposure to offshore assets doesn't move with the rand when it strengthens or weakens; it only accrues the rate differential. This means that by partially hedging our currency exposure, we still participate when the rand weakens, but we do it in a much smoother way.

The chart below illustrates the standalone volatility profiles of several offshore assets (dark blue line) without hedging. Once we overlay the hedge, we observe a significant drop in volatility, particularly in fixed-income assets, making them much more attractive investment opportunities.

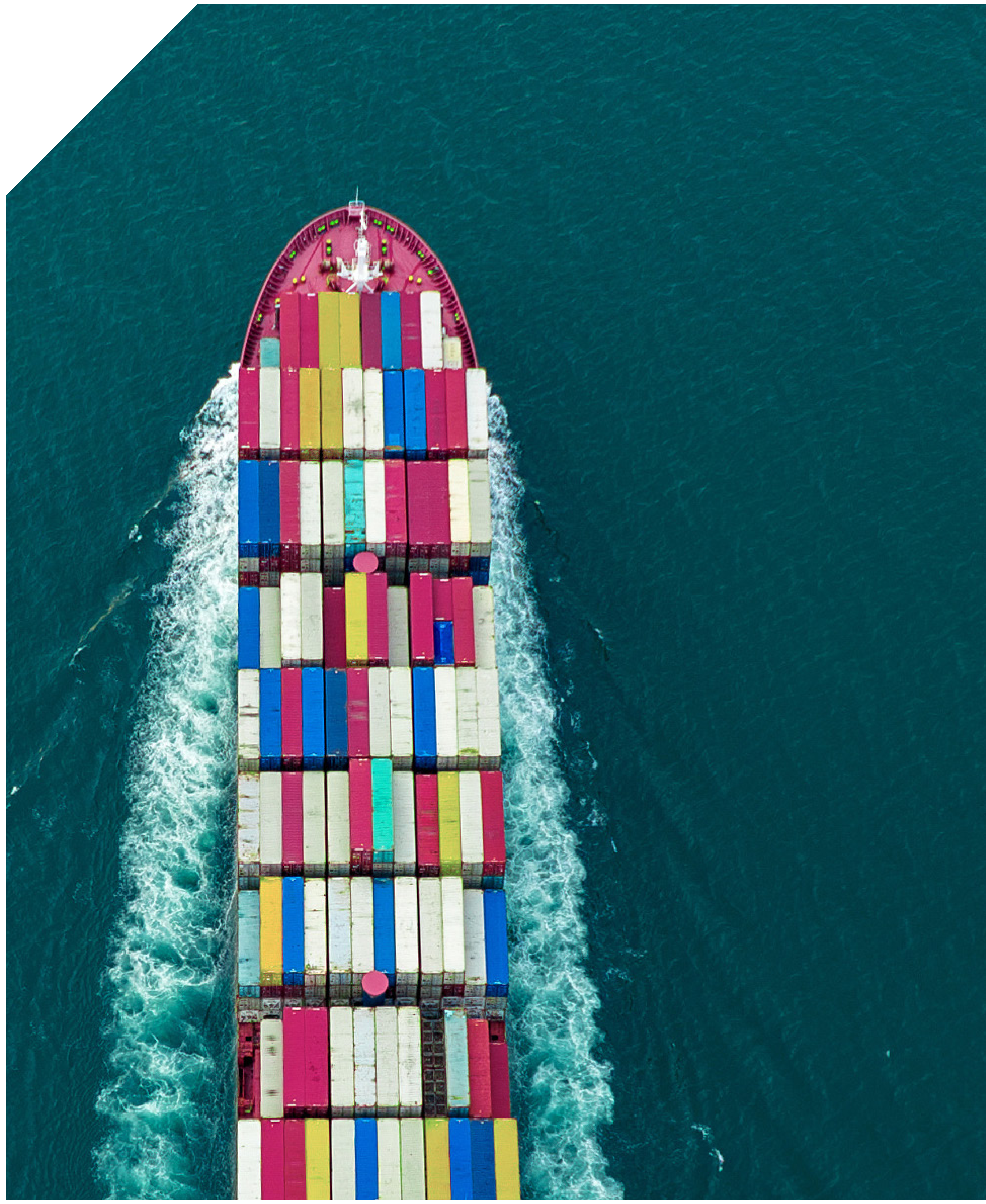
Currency Hedging's Effects on Asset Volatility



Source: Bloomberg, Prescient Investment Management as of 30 June 2024

By reducing currency risk, we also open ourselves up to a broader opportunity set of offshore assets. Why is this important? The answer is diversification. We are optimistic about the benefits of South African assets, but as the saying goes, we don't bet the farm or put all our eggs in one basket. To diversify away the idiosyncratic risks in the country, we need to look offshore as well. What better way to do this than using currency hedging as another tool in our multi-asset toolbox?

In our Multi-Asset funds, we do not sacrifice portfolio performance by hedging currency risk but reduce volatility. This allows us to target CPI+6% in our Prescient Balanced Fund with less risk for our clients, achieving consistency in performance more deliberately. After all, who wants to take on unwarranted risk when investing?



Rounding the corner: equity market still offering great value

by SEEISO MATLANYANE
Head of Equities

Emerging market equities and particularly local equities, continue to offer better value relative to developed markets.

Despite what may be termed a tale of two starkly different performance quarters, the first half of 2024 concluded on a positive note for local equity investors. We saw the FTSE/JSE All Share Index (J203T) deliver a total return of 5.75% for this period despite an unsteady first quarter that left the market down 2.25%.

> Gratefully, however, this was followed by a solid 8.19% rally in the second quarter, which returned portfolios to firmer ground. As we cross the midway point, it is worthwhile considering our footing relative to market expectations at the beginning of the year to better understand what the second half may yet have in store.

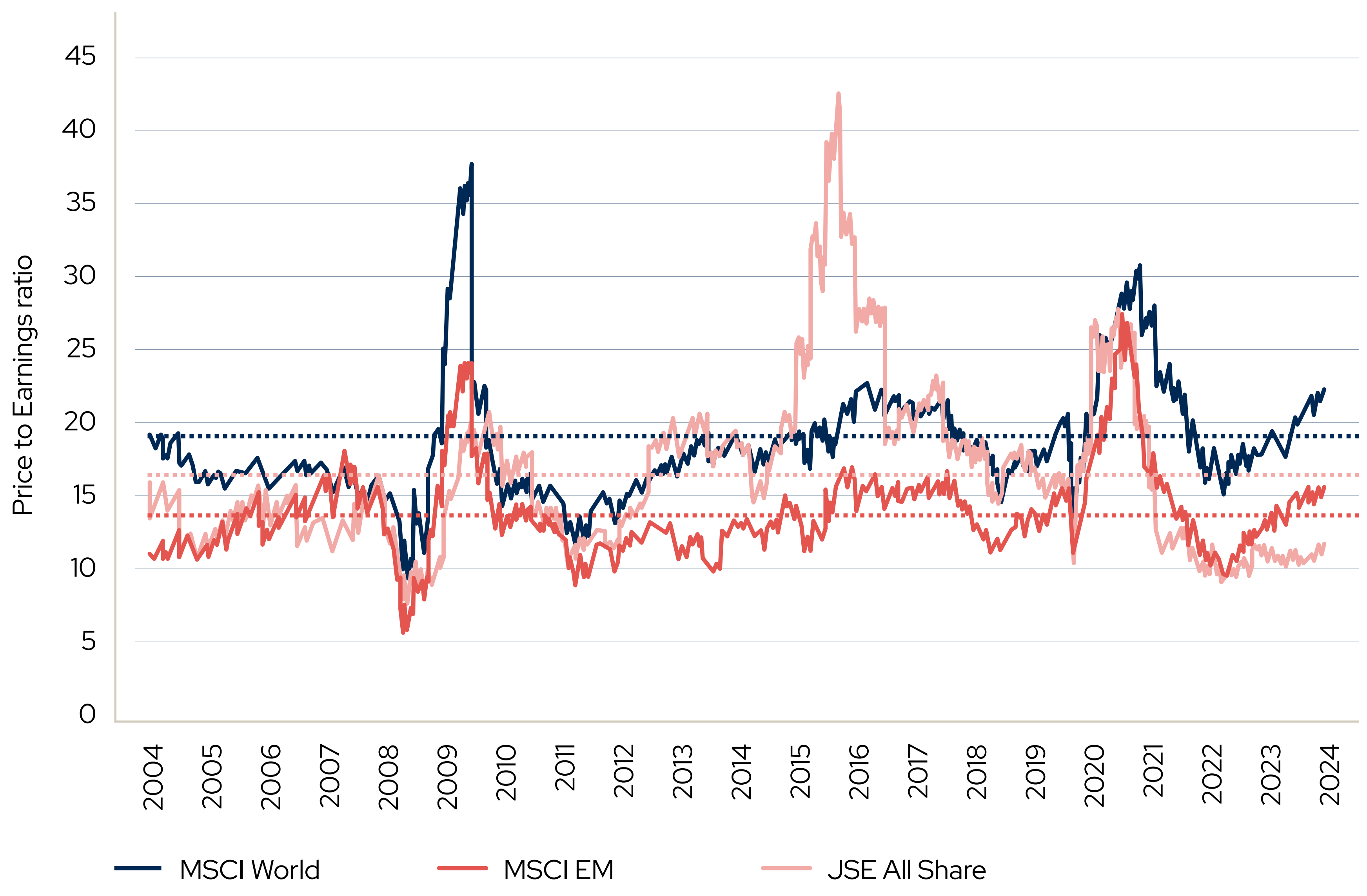
In the aftermath of an all-out war against rising prices, the year was ushered in on near-term expectations of monetary policy easing. The unforgiving central bank efforts to arrest a potentially catastrophic wage-price spiral—which, on the other hand, had given probable cause for concern over a similarly devastating stagflation scenario—seemingly hit the mark. Hard data illustrated signs of remarkable economic fortitude. Inflation was meaningfully subsiding, and growth estimates were being revised upwards.

Nonetheless, with nearly half the world's population expected to visit the polls this year, 2024 promised to be a massive election year. The ensuing uncertainty regarding fiscal policy direction, not to mention the destabilising and unpredictable backdrop of ongoing geopolitical conflicts in Ukraine and the Middle East, served as some of the key risk factors keeping the bulls honest.

This initial period of the year has been chiefly characterised by a series of further-dated revisions to the rate outlooks. As of the end of June, the European Central Bank (ECB) and the Bank of Canada (BoC) are the only monetary authorities of the major economies to have delivered on any of the many anticipated rate cuts this year. This, of course, was the natural downside risk to the dovish market outlook, and notwithstanding, equity investors, particularly in Developed Markets, have reaped solid gains.

The MSCI World Net Total Return Index ended the half up an impressive 11.7% in US dollars. While this is admittedly mostly attributable to a concentrated contingent of US technology shares, it would be remiss to gloss over the fact that earnings have also impressively kept up with expectations. This performance run has left investors with stretched valuations and even loftier earnings expectations for the developed world.

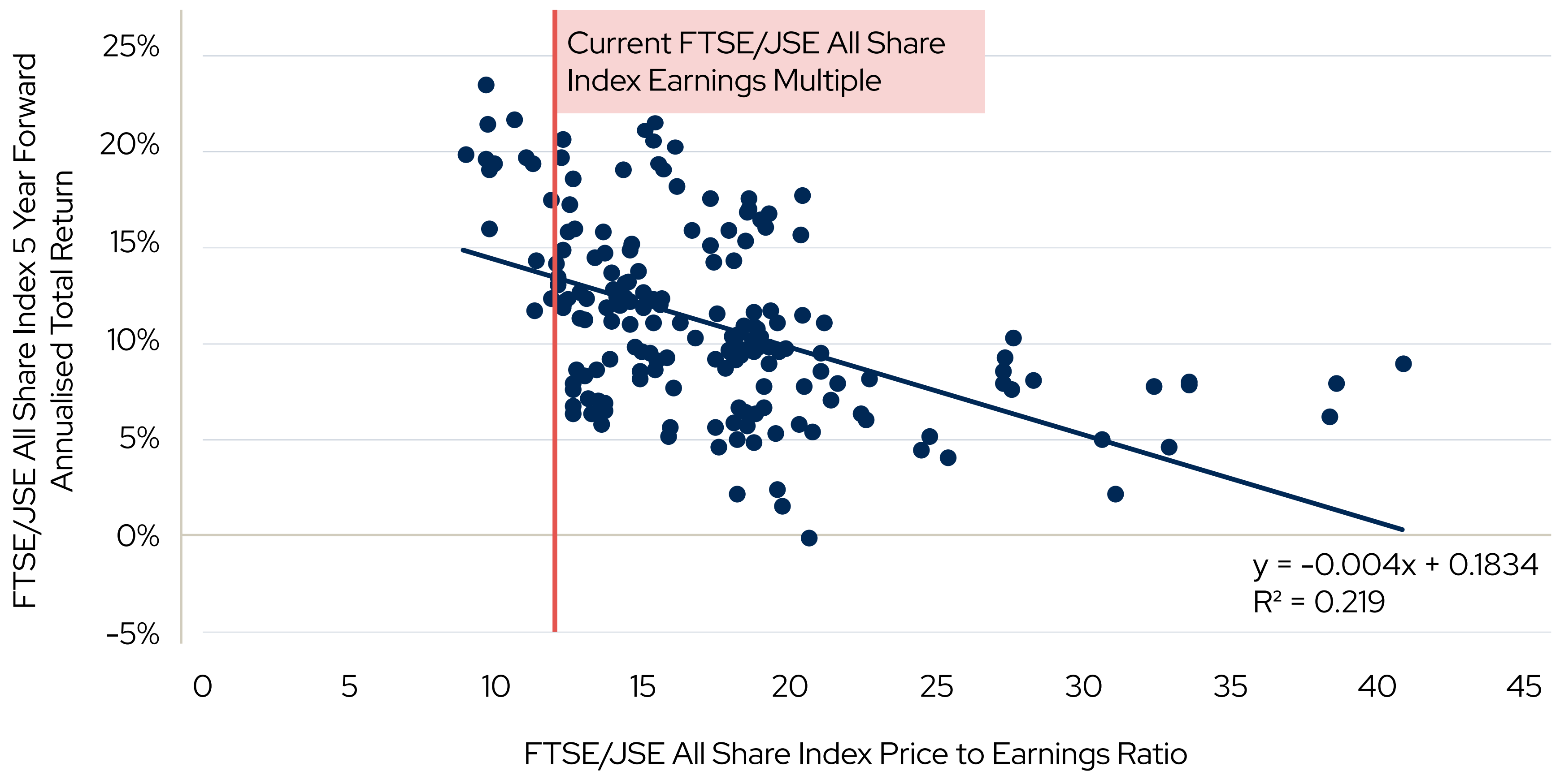
Price to Earnings Ratios



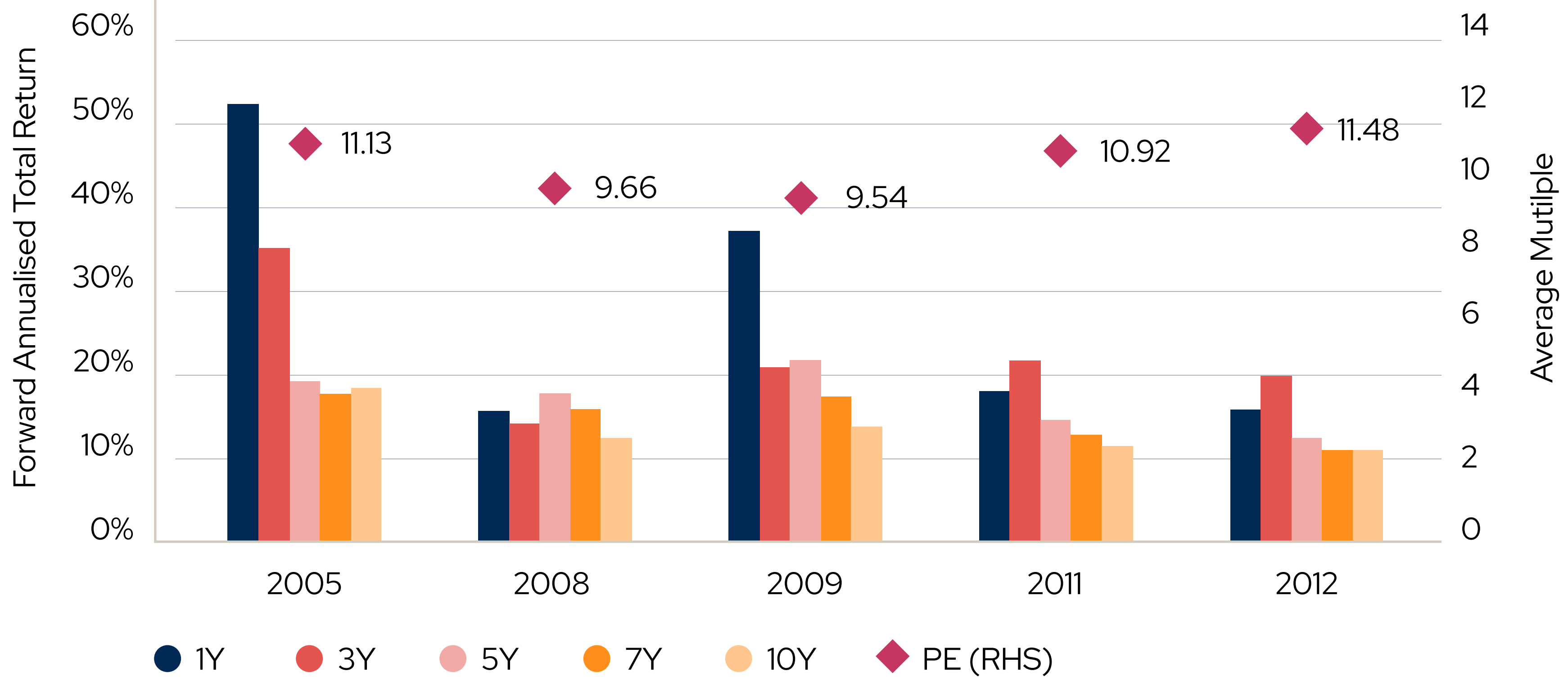
Source: Prescient, Bloomberg as of 30 June 2024

With earnings multiples of approximately 16 times and 12 times, respectively, emerging market equities and particularly local equities, continue to offer better value relative to developed markets trading at closer to 22 times. The FTSE/JSE All Share index stands out as particularly attractive, even relative to its own long-term average multiple. A rudimentary but objective assessment of these valuations serves as a prudent starting point for a profitable allocation decision for the upcoming periods.

Historical multiples and subsequent returns



Source: Prescient, Bloomberg as of 30 June 2024



Source: Prescient, Bloomberg as of 30 June 2024

Monthly data shows that over the last 20 years the local equity market has offered similar or better multiples on only five distinct occasions. These were in 2005, 2008, 2009, 2011 and 2012. The subsequently realised total returns following each of those distinct periods have historically been unsurprisingly strong for investors.

While we must caution that historical returns are by no means an indication of future performance and concede that markets are undoubtedly driven by more than just valuations, local equity investors may find there's a strong objective case for further upside going forward in these numbers. This is especially true when one considers the inevitable dispersal of some key risks to this outlook as we move on from the local election uncertainty, with our democracy intact, towards what are now easier monetary conditions.

What is systematic bond investing?

by REZA ISMAIL
Head of Bonds

The implementation of systematic approaches in fixed-income markets necessitates the utilization of advanced technological solutions and sophisticated analytical techniques.

Prescient is a leading systematic investment house, with a long and distinguished history of employing quantitative strategies and data-driven insights to optimise investment decision making. Prescient is in many respects the systematic investing forerunner in the South African asset management space and has long since employed the methodologies that have recently become "en vogue" with the advent and commercialisation of big data, artificial intelligence, and other popular descriptors for what are in many cases standard statistical techniques for those familiar to the terrain.

> Our approach to bond investment has developed in full systematic fashion over the past two decades. Globally, particularly in the fixed income space, there has been a clear migration towards systematizing investment processes in order to make investment outcomes more transparent, consistent, inheritable and repeatable.

In this article we hope to articulate Prescient's systematic approach to bond investing, with reference to how we have navigated the recent atypical volatility espoused by the South African sovereign yield curve. Financial journalists and non-specialists have posited a wide array of explanatory phenomena for these recent swings, mostly centred around local idiosyncratically South African developments such as the developments around the national election and ostensibly, what the ramifications of these electoral outcomes mean for financial markets. Similiar atypical and outsized movements were recently also observed in other foundational South African fixed-income markets such as those for interest-rate swaps and tenor-specific bank deposits.

We at Prescient acknowledge that from time to time, local idiosyncratic phenomena ("Nenegate", the "Lady R" vessel saga, political reconfigurations) can indeed have a bearing on the local bond market. However, our contention is that (a) the scope of influence on financial markets these events have is short-lived, and more importantly (b) the quantitative evidence suggests that the effects these episodes have are nothing more than statistical noise around a long-term trend or performance line, and that line in turn is influenced and driven mainly by global phenomena.

How we reach these conclusions and how we are able to express degrees of confidence in these assertions is the subject matter of this article.

What really drives the bond market: Prescient's systematic approach to bond investing

Systematic fixed-income investing is an active approach that aims to outperform bond market benchmarks – in the South African context this would very often mean the familiar All Bond Index. At its core, a systematic process aims to identify measurable factors which have been proven statistically to have explanatory power for asset price performance. Potential factors are identified and tested according to sophisticated econometric techniques but could intuitively be understood as a multi-variable regression in which one aims to identify the most powerful explanatory variables, whilst trying to maintain a parsimonious model.

Some factors often matter more than others. An effective model needs to recognize and allow for relative importance, which is what we have incorporated in our process. We generally always favour relatively simple but robust econometric techniques for stronger predictive power and greater transparency.

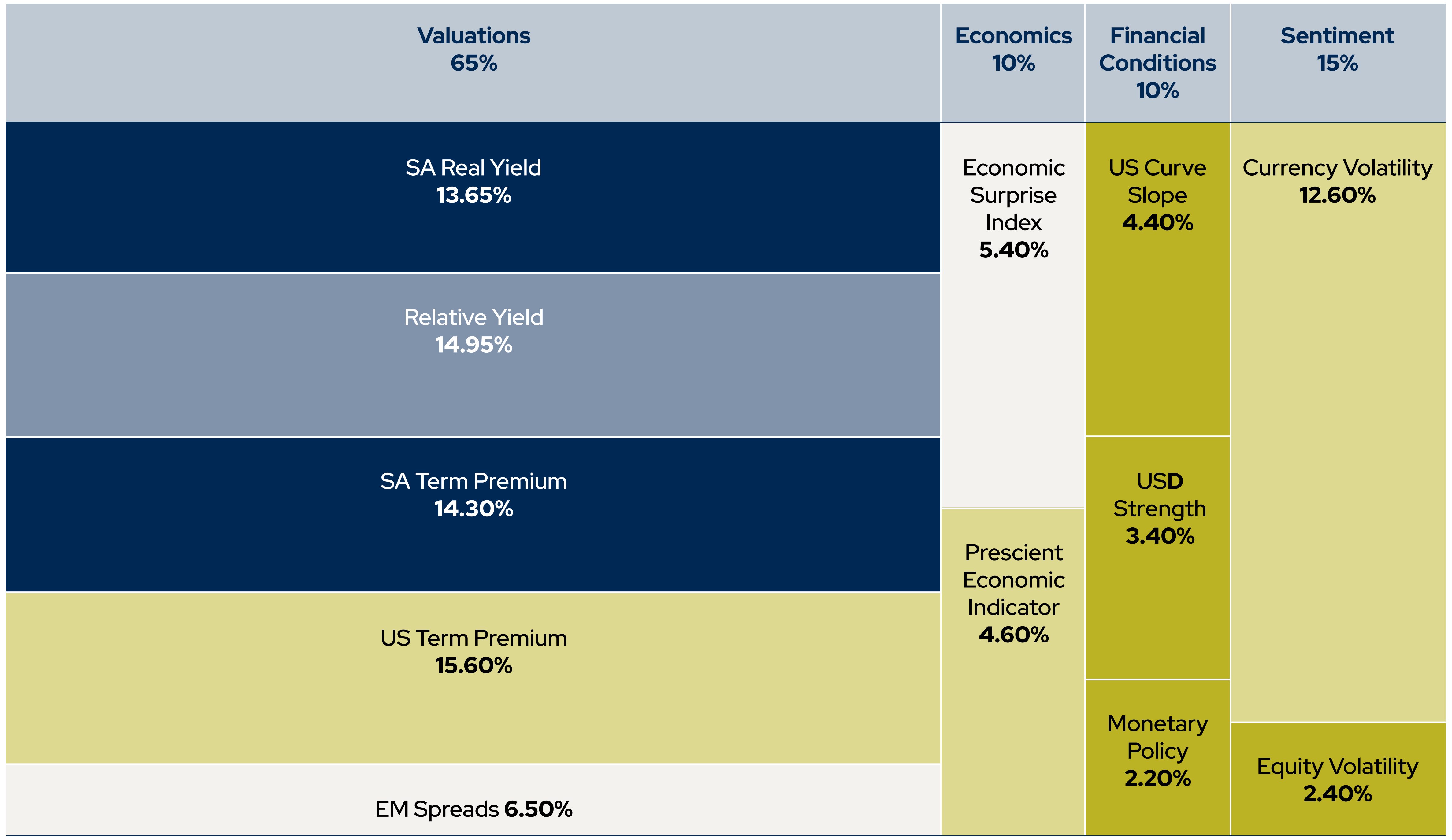
This approach is "active" and clearly differentiated from pure passive and "smart beta" solutions, as these rely on replicating either indices or static risk exposures. It also represents a different but complementary approach to traditional active bond management. Traditional active portfolios may harness some of the same factors and technology as systematic investing but are skewed much more towards fundamental research rather than a model-based process to select securities.

Factors are then grouped into intuitive meta-headings such as "Valuations"; those factors relating to the price of the asset itself, "Economics"; factors generally related to the level aggregate demand in the most consequential economies, "Financial Conditions"; which consists of factors measuring how conducive financial conditions such as borrowing costs are to the global business cycle and finally, "Sentiment"; which collects certain factors that relate to aggregate positioning, often reflective of excessive optimism or pessimism embedded in the traded market. The image below shows how these factors combine to form the South African Bond's process "factor mosaic". Note: the percentages indicate relative weights of a specific factor to the overall score

Because investment regimes change over time, a robust model needs to be dynamic rather than static. This allows the predictive factor combinations to evolve with market changes and avoid being hamstrung with factors that performed well in a previous but now outdated regime. A systematic investment process should be constantly evolving, dynamically adjusting the factor weights as their efficacy changes, adding new factors once their efficacy has been demonstrated and removing old factors once their efficacy has faded.

> By persistently striving to evaluate and broaden the spectrum of accessible factor choices, systematic investors can enhance their opportunity set and augment the likelihood of attaining superior risk-adjusted returns. A reliance solely on traditional, widely recognized factors constrains the opportunity set and diminishes the probability of success.

Factor Score Breakdown



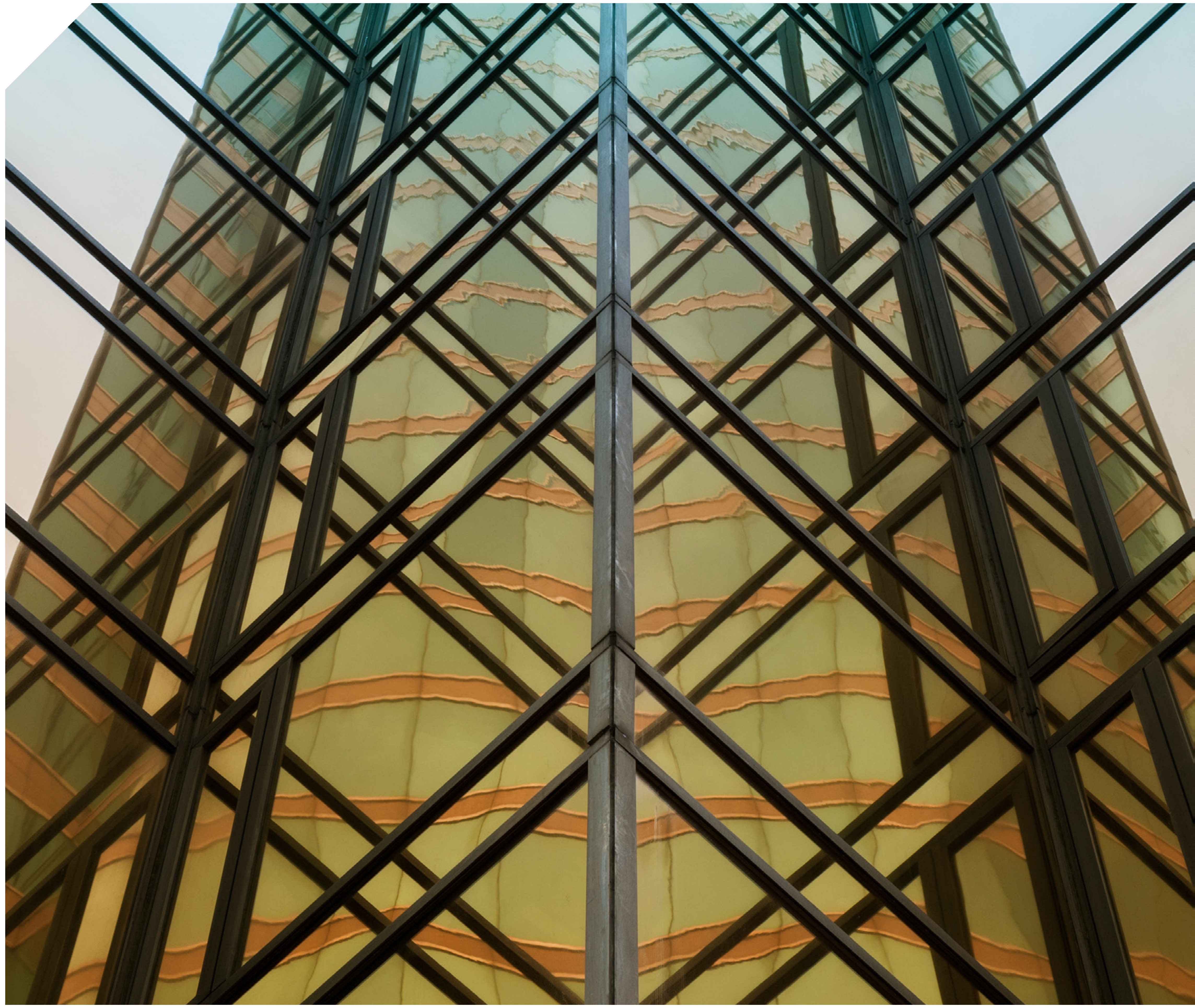
Source: Prescient Investment Management as of 30 June 2024

Contrasts with "fundamental" bond investment processes

Systematic active investment strategies seek to generate value through methods distinct from those employed by traditional fundamental approaches. The core competencies of systematic managers are centred around the identification of predictive factors and the construction of portfolios guided by established benchmarks and rigorously tested rules. In contrast, traditional active managers leverage more idiosyncratic insights, encompassing a subjectively chosen spectrum of factors and markets. These insights may pertain to potential corporate changes, merger and acquisition activities, private markets, and other unique or esoteric situations. For instance, they could feature country assessments of political changes, considerations which do not ordinarily lend themselves to quantitative measurement and testing.

Traditional actively managed strategies construct portfolios based on conviction levels surrounding issuers, sectors, and other related factors. This process is heavily influenced by the manager's accumulated experience and expertise and ultimately, subjective judgment. This realisation, that human behavioural "hard-wiring" could lead to cognitive dissonance and sub-optimal decision making, was a large part of the original core tenets of the Prescient investment philosophy which is rooted in empiricism and objectively defensible investment decisions. To address this, systematic fixed income strategies require portfolio managers and analysts to determine, test, and augment predictive factors, review data integrity and evaluate model-suggested outcomes for credibility, thereby minimizing bias.

Predictive factor-based methodologies were initially developed within equity markets, where benchmark construction is relatively straightforward, and pricing mechanisms exhibit a high degree of transparency. These methodologies have been more recently adapted to fixed-income markets, which are characterized by greater scale, complexity, and fragmentation across various trading platforms. Such features exacerbate the challenges associated with liquidity and price discovery in bond markets. Consequently, the implementation of systematic approaches in fixed-income markets necessitates the utilization of advanced technological solutions and sophisticated analytical techniques. Despite the theoretical support from academic research for the applicability of predictive factors in fixed income, the creation of successful portfolios demands rigorous empirical testing and robust practical implementation capabilities.



Investing in uncertain times – it's worth exploring the alternatives to money market funds

by CONWAY WILLIAMS
Head of Credit

Investors need not be limited to money market funds for fixed-income investments. Flexible income funds offer a compelling alternative.

Investing in South Africa's fixed-income market amid various uncertainties, socio-economic issues, elevated yields, and sluggish growth can be a challenging endeavour. In such a tough economic environment, many investors' first instinct is to put their savings into safe-haven funds like money market funds.

Numerous opportunities are available for investors seeking risk-adjusted returns without being confined to traditional money market funds. While money market funds have played an important role during the recent hiking cycle, it is our view at PIM that there are in fact real alternatives. Simply put, confining investments to money market assets during tough economic times means potentially missing out on better returns available in other investment vehicles, with proven managers who place risk management at the heart of what they do. Income funds, for example, offer flexibility and, under the assumption that capital preservation, risk management, and volatility are thoroughly considered, can be a compelling option.

This article explores these alternatives and highlights their benefits in the current South African market environment.

Flexible Income Funds – the alternative

As alluded to, flexible income funds offer a robust alternative to pure money market funds. These funds aim to optimise income potential and safeguard capital by dynamically allocating assets across various classes. Simply put, these funds provide high levels of income to investors, take advantage of exposure to income-generating assets, and, while being risk-conscious, generally offer returns in excess of cash.

Flexible income funds are investment vehicles that allocate capital across a broad spectrum of income-generating assets. Unlike traditional funds, they are not restricted to a single asset class but can invest in bonds, property, preference shares, inflation-linked bonds, derivatives, and offshore cash and bonds. This flexibility allows fund managers to adjust allocations based on market conditions to maximise returns while protecting capital.

> Thus, they have become a significant segment of the South African investment landscape due to their versatility and performance. The flexible income fund sector in South Africa has grown substantially, reflecting its popularity among investors.

As of the latest reports, using the ASISA Multi-Asset Income category as a proxy for income funds, the combined assets under management (AUM) have grown from R312 billion (30/6/2023) to cR380 billion (30/6/2024) across 134 different funds. This growth underscores investors' confidence in these funds' ability to navigate complex market environments and deliver consistent returns.

As noted above, flexible income funds generally aim to deliver returns in excess of cash. Our research suggests that return targets for these funds typically range from the equivalent of 1% to 4% above inflation over the medium to long term. This objective is achieved through active management and strategic allocation across various income-generating assets.

Performance and Value Delivery

Importantly, flexible income funds are designed to deliver value by adjusting their asset allocation to capitalise on market opportunities. For example, they can invest in inflation-linked assets during inflationary periods or shift to high-quality bonds when interest rates are expected to fall.

This dynamic approach allows these funds to generate stable income while minimising risk. Moreover, their ability to include alternative income sources like preference shares and property enhances their return potential.

Flexible Income Funds at Prescient

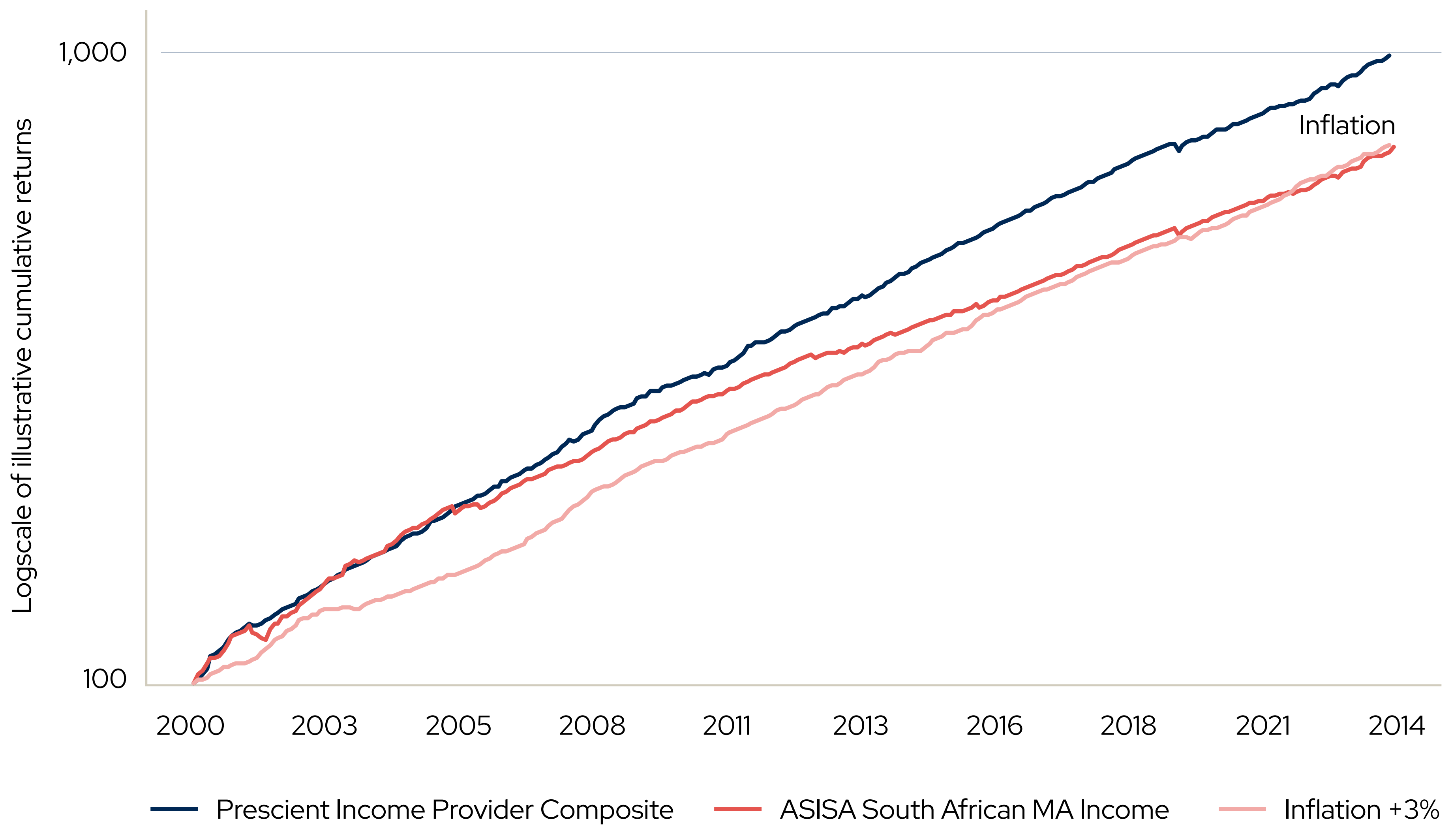
Within our stable, our flagship flexible income funds are our long-standing Prescient Income Provider Fund and the more recent Prescient Income Plus Fund. Both fall within the ASISA Multi-Asset Income category. Both are managed in the systematic style Prescient Investment Management is highly regarded for, with the only difference between the two being the mandated risk tolerance.

Figures 1 and 2 below highlight the illustrative cumulative returns for the Prescient Income Provider Fund and the Prescient Income Plus Fund.

As is evident in the above, the performance of both funds continues to stand out within the category, and in relation to the fund targets. This has been achieved through careful asset allocation, the use of duration, and also where and when appropriate, the inclusion of credit instruments.

Figure 1: Income Provider: Illustrative Cumulative Returns

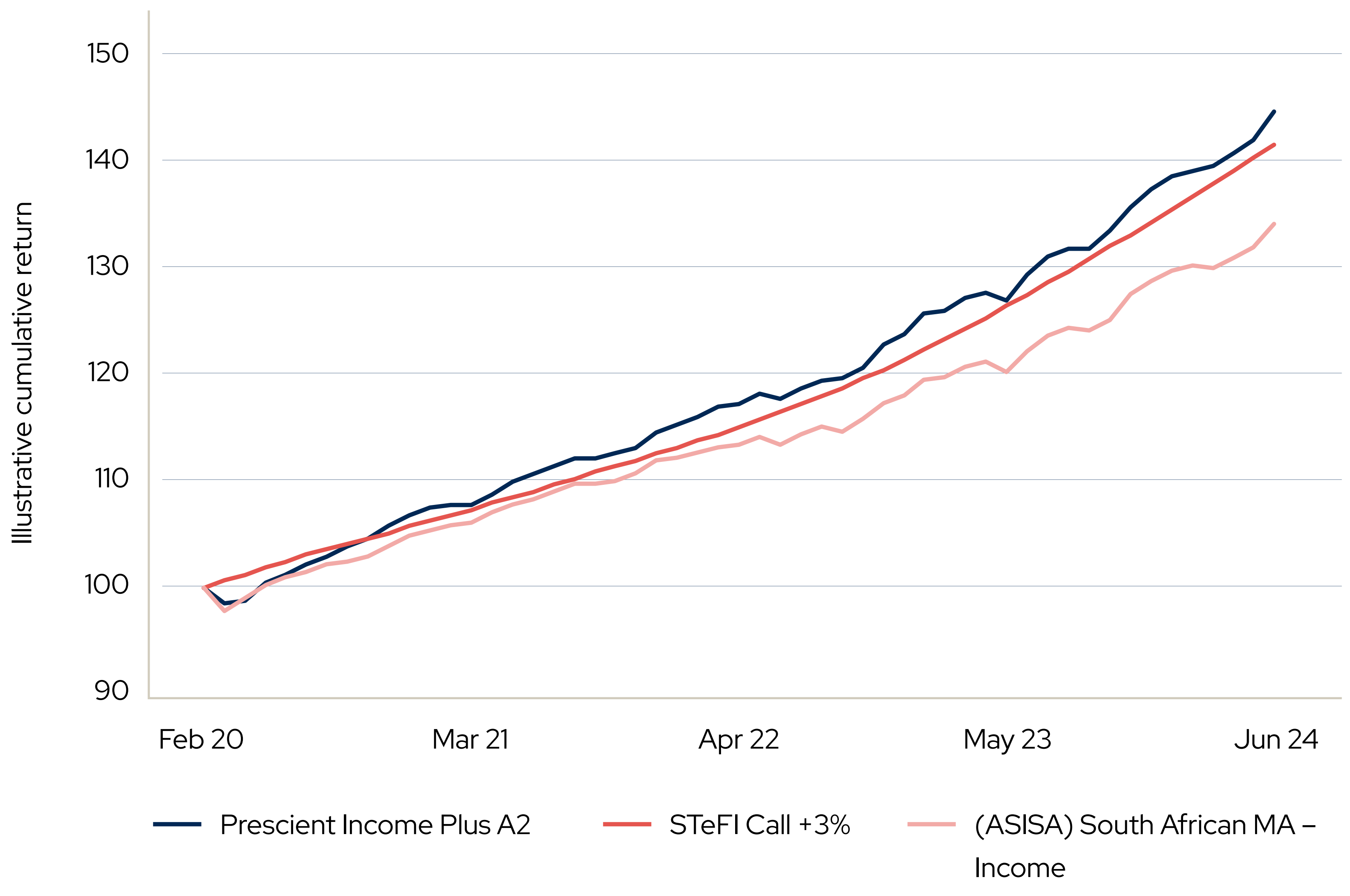
Gross returns to 30 June 2024. Inception of PIPF Fund January 2006



Source: Prescient Investment Management, as at 30 June 2024.

Figure 2: Income Plus: Illustrative Cumulative Returns

Net returns to 30 June 2024. Inception of the fund March 2020.



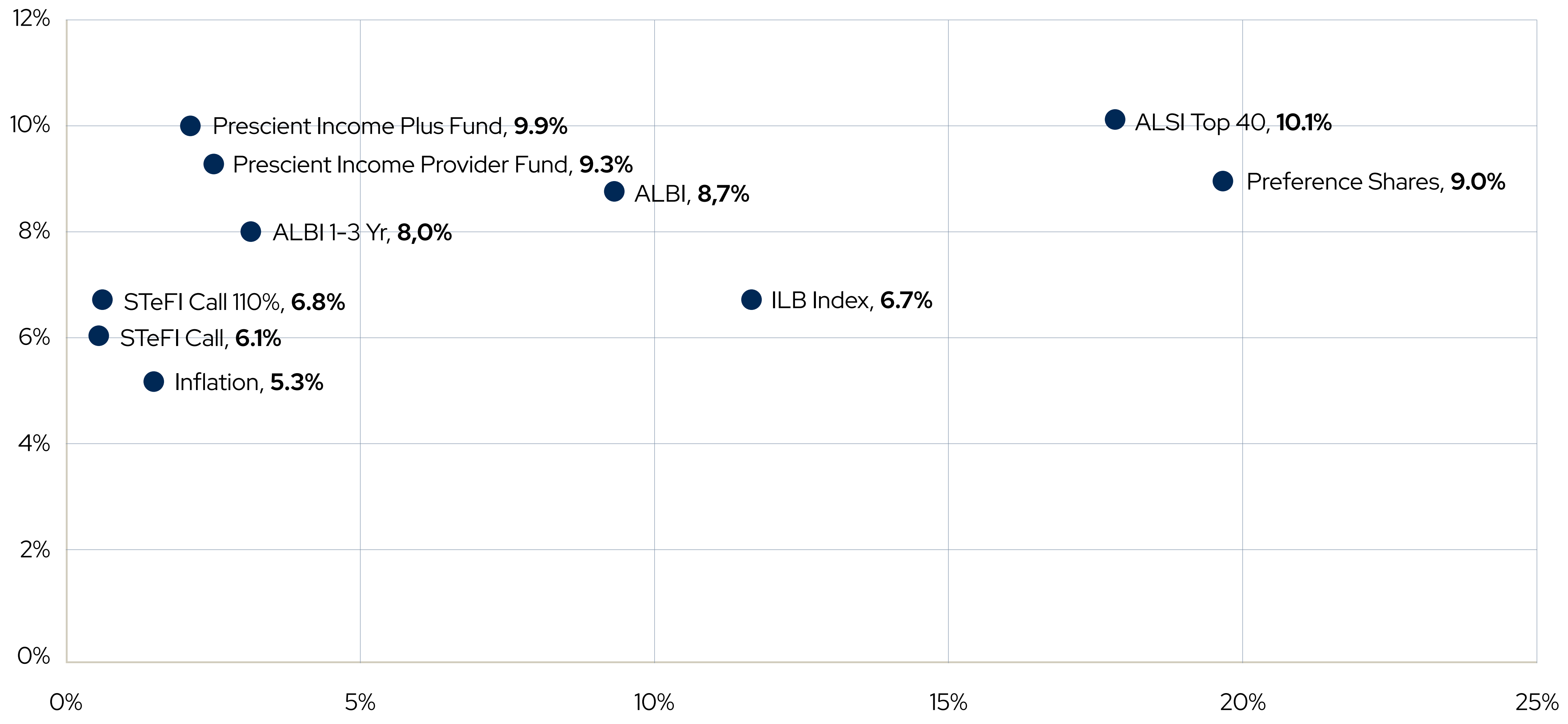
Source: Prescient Investment Management, as at 30 June 2024.

We would be remiss in our duty if we did not talk to our robust systematic investment process - Prescient's approach to investing is systematic: our process is well-defined, researched, back-tested, and sufficiently forward-looking to prepare for various market movements that may come. This is the cornerstone of how we craft our portfolios, and importantly, our risk management strategies across investment cycles.

Additionally, we emphasize what we term "risk-adjusted returns" for these funds. This concept considers the annual performance of the funds relative to their volatility (i.e., the annual standard deviation). As demonstrated across various indices and proxies in Figure 3 below, while achieving robust returns, the consideration of downside risk remains evident, shown in this simple risk measure.

Figure 3: Risk Returns

Net returns to 30 June 2024. Inception of PIPF Fund January 2006; Inception of POPFP Fund March 2020.



Source: Prescient Investment Management, as at 30 June 2024.

	Highest Rolling 1 Year	Lowest Rolling 1 Year	Highest Rolling Benchmark	Lowest Rolling Benchmark
Prescient Income Provider Fund	14.29	4.04	12.59	3.86
Prescient Income Plus Fund	11.96	6.51	11.22	6.63

Lastly, an important consideration for risk-conscious investors is that 83% of the months over the past 25 years have been positive in the Prescient Income Provider Fund, and the Prescient Income Plus Fund has never had a negative quarter. This consistent performance highlights the effectiveness of our risk management strategies across investment cycles and, importantly, our ability and commitment to providing stable, reliable returns for our investors.

How do investors access these funds?

Investors can access flexible income funds through various channels:

- **Financial Advisors:**

  Consulting with financial advisors who can recommend suitable flexible income funds based on individual risk profiles and investment goals.

- **Investment Platforms:**

  Utilising online investment platforms that offer a range of flexible income funds for easy access and management.

- **Direct Investment:**

  Investing directly through asset management companies that manage flexible income funds, providing direct exposure to the funds' performance.

In the face of South Africa's economic challenges, investors need not be limited to money market funds for fixed-income investments. With their diversified asset allocation and dynamic management, flexible income funds offer a compelling alternative. These funds are designed to navigate various market conditions, whether high or low interest rate environments, by investing in a wide range of income-generating assets. This flexibility and active management allow these funds to deliver on client promises, with the performance and risk measures of the Prescient funds shown above a testament to this.

Investing in South Africa's fixed-income market requires a strategic approach, balancing income potential with capital protection. It is our long-standing view as Prescient Investment Management that flexible income funds present a versatile and effective solution in today's uncertain economic landscape. Utilizing these funds will enable investors to not only navigate the complexities of the market, but importantly, achieve their financial objectives.

Patience and profit: navigating SA Cash and Income investments

by HANNAH DE NOBREGA
Quantitiative Analyst*

and MICHELE VAN DER BERG
Portfolio Manager

The current high interest rate environment is ideal for the Cash and Income space in South Africa.

*Representative acting under supervision.

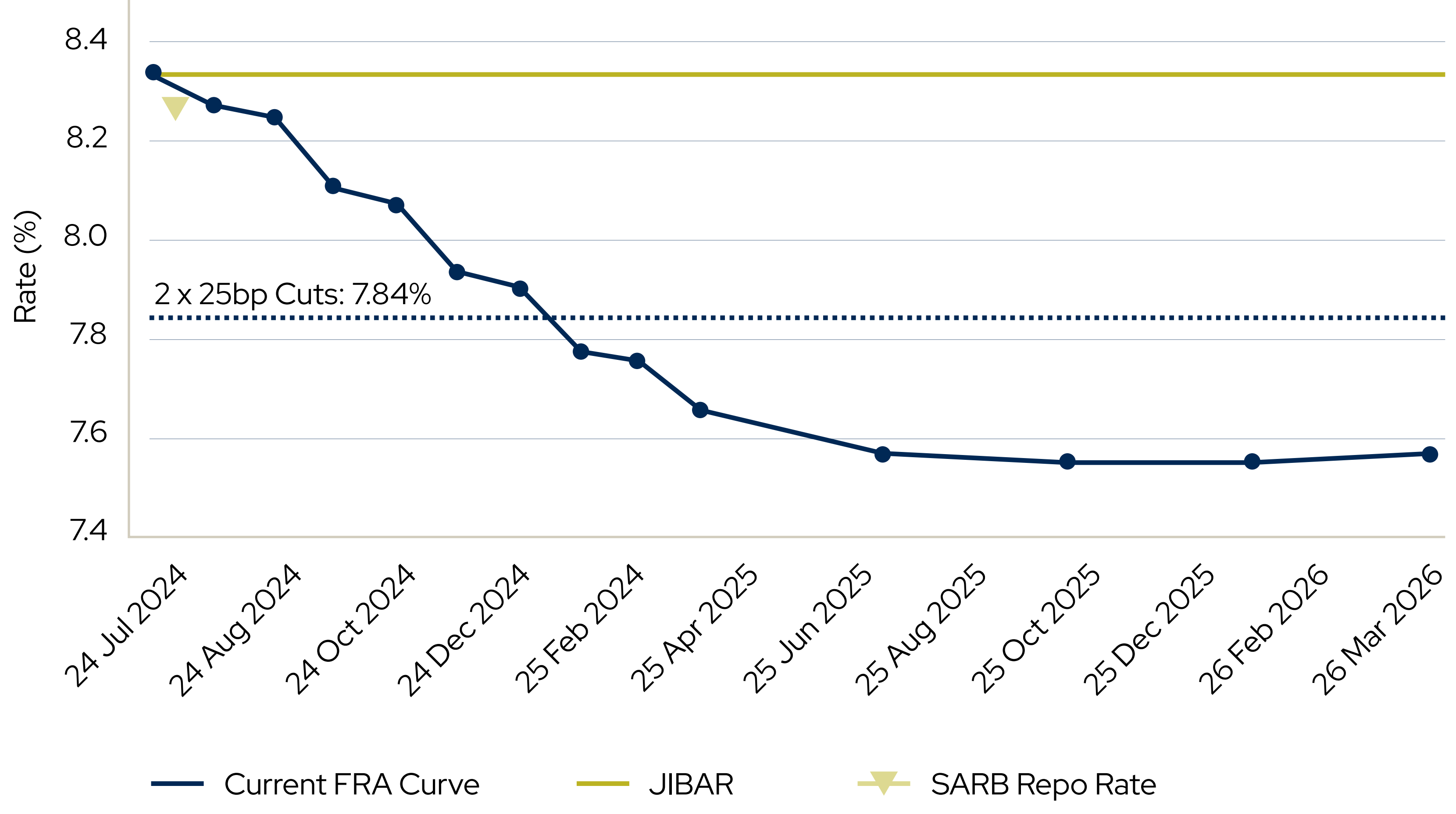
Despite core inflation returning to 4.5%, the SA Reserve Bank remains hawkish, saying risks in South Africa continue to be balanced, so it is premature to expect a reversal of the current high interest rate cycle. Against this backdrop, what possibilities exist for investors if the front of the yield curve remains high and they can be paid for investing in cash and income investments that are relatively short in duration?

> Despite yield pressure in South Africa, domestic investors can earn high real rates at the front end of the yield curve. Due to the high global interest rate regime, the Money Market and Enhanced Cash Fund returns of 9% to 10% make for attractive opportunities in this market segment.

Global

The notion of a soft landing suggests that the US Fed is not under pressure to cut rates quickly and sharply. At Prescient Investment Management (PIM), we use our in-house now casting model, the Prescient Economic Indicator (PEI), to track GDP growth in the United States. This indicator enables us to obtain a real-time perspective on the areas where the US economy is expanding or contracting. Based on our PEI, we expect GDP growth to contract from 2.9% to 2%. The contraction is predominantly due to the weakening labour market and economic conditions. High job vacancies in the construction industry and high unemployment rates among people with bachelor's degrees are the most significant drags on the labour market. Furthermore, a decline in the US manufacturing industry is the largest contributor to the deteriorating economic conditions in the US. Therefore, the Fed may announce a cosmetic rate cut this year. However, given the risks to economic growth and the labour market, the Fed's appetite to cut rates is somewhat conservative. From the chart below, markets seem to be pricing in this outcome.

Market pricing: Key Rates vs Forward Rate Agreements



Source: Prescient Investment Management, Bloomberg as on 2024-07-10

The European Union, on the other hand, has begun their interest rate-cutting cycle for the first time in five years, reducing rates from 4% to 3.75%. This is a conservative cut and they may continue to cut rates slowly.

Domestic

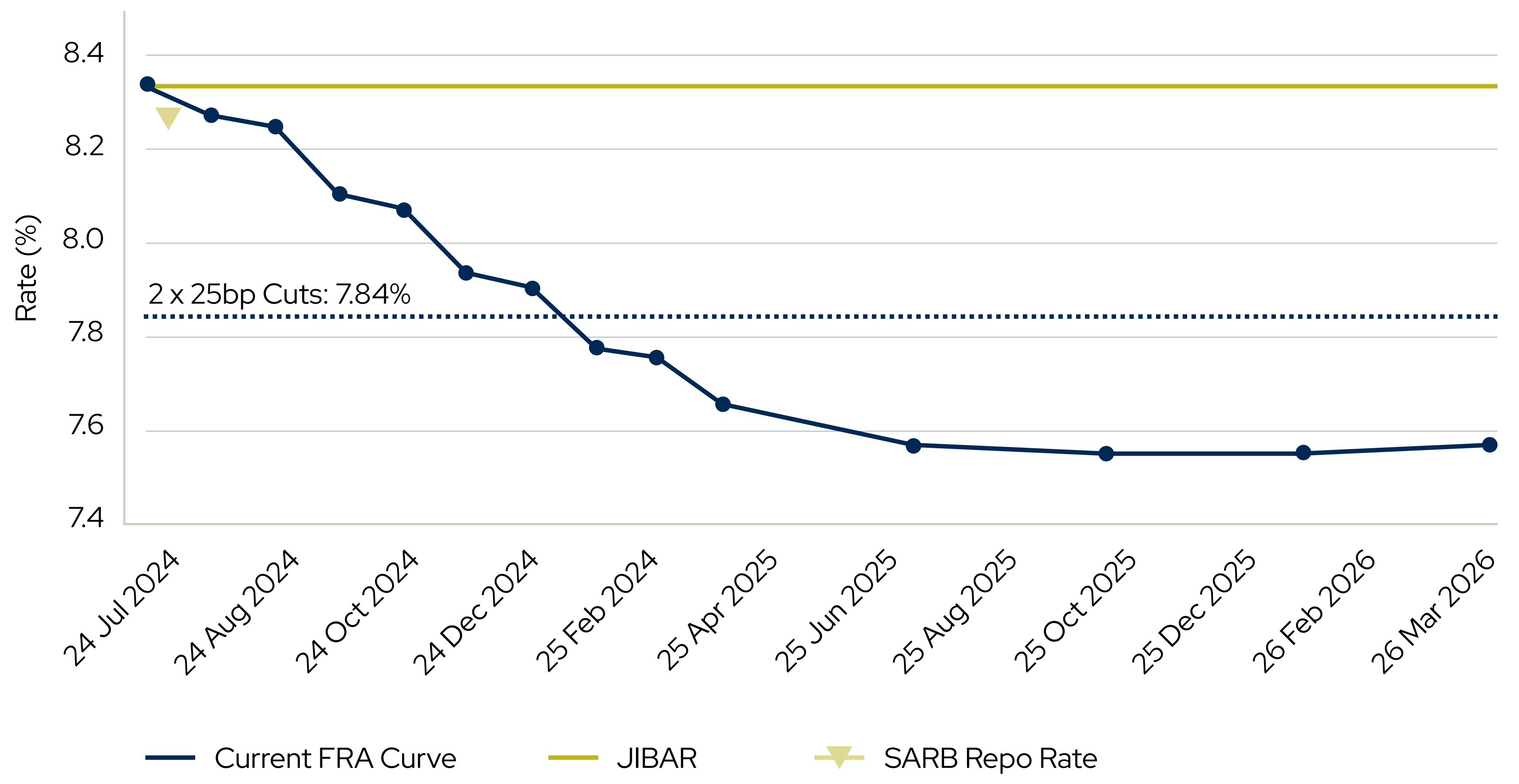
In South Africa, core inflation is broadly contained near 4.5%. Monetary policy has helped limit the second-round effects from headline inflationary shocks. Domestically, food inflation has fallen back to its 2022 levels after a large surge in these prices in 2023. However, grain prices may still rise due to a hotter summer end than usual. The South African Reserve Bank (SARB) discerns that the overall risks to inflation remain balanced, such that South Africa faces risks to inflation in both negative and positive directions.

There is a large amount of uncertainty around inflation expectations. Some respondents have a high degree of optimism, while others are pessimistic. SA inflation is high relative to its peers, only because SA has a higher inflation target than its peers. This has given the SARB grounds for targeting core inflation at 3%. If a new inflation-targeting regime were to be implemented, we could see interest rates remain at their current level for the medium term. Consequently, lower nominal interest rates should prevail in the long run. Nonetheless, the SARB has not yet committed to a new inflation targeting regime; hence, in the meantime, the market is pricing rate cuts in line with the SARB's Quarterly Projection Model (QPM). The QPM suggests an already gradually easing repo rate because it forecasts the output gap will close, with headline inflation at 4.5% by the second half of 2025.

> It is important to note, however, that the MPC has clearly communicated that policy will remain restrictive and that there is no appetite to begin rate cuts before headline inflation actually reaches 4.5% due to the risks dominated at the beginning of 2024; thus, the MPC is not following the rate-cutting path suggested by the QPM.

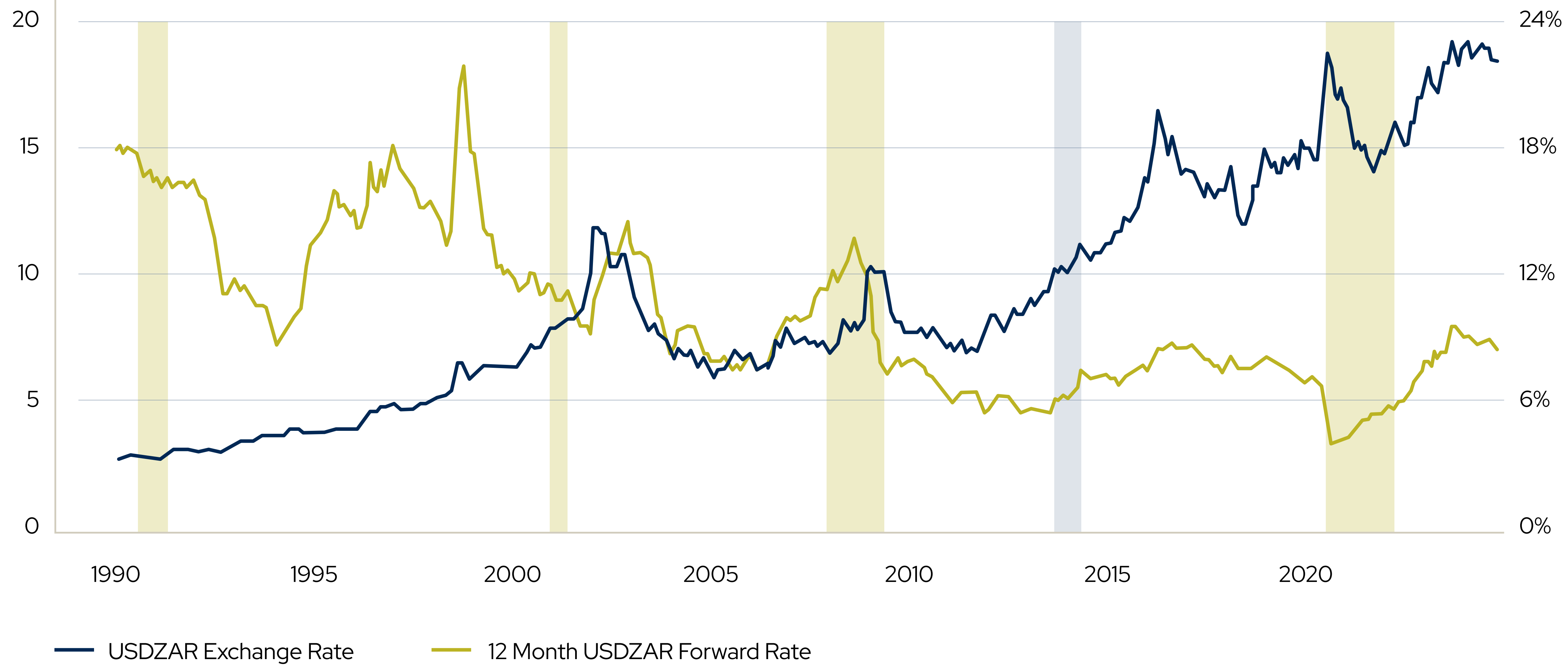
Historically, the rand's passthrough to core inflation has been relatively low (at 0.13), which has allowed policymakers to use the freely floating rand as a shock absorber in the past. However, more recently South Africa has experienced volatility in core goods inflation derived from external global shocks. Thus, there is cause for concern that the exchange rate passthrough is growing, reducing the effectiveness of the rand as a buffer from external shocks to inflation. In other words, the rand is showing signs of becoming more correlated with other factors of the economy, thus providing South Africa with less protection from global price shocks, consequently increasing upside risks to inflation.

Market pricing: Key Rates vs Forward Rate Agreements



Source: Prescient Investment Management, Bloomberg as on 2024-07-10

USDZAR Exchange Rate and Forward Rate



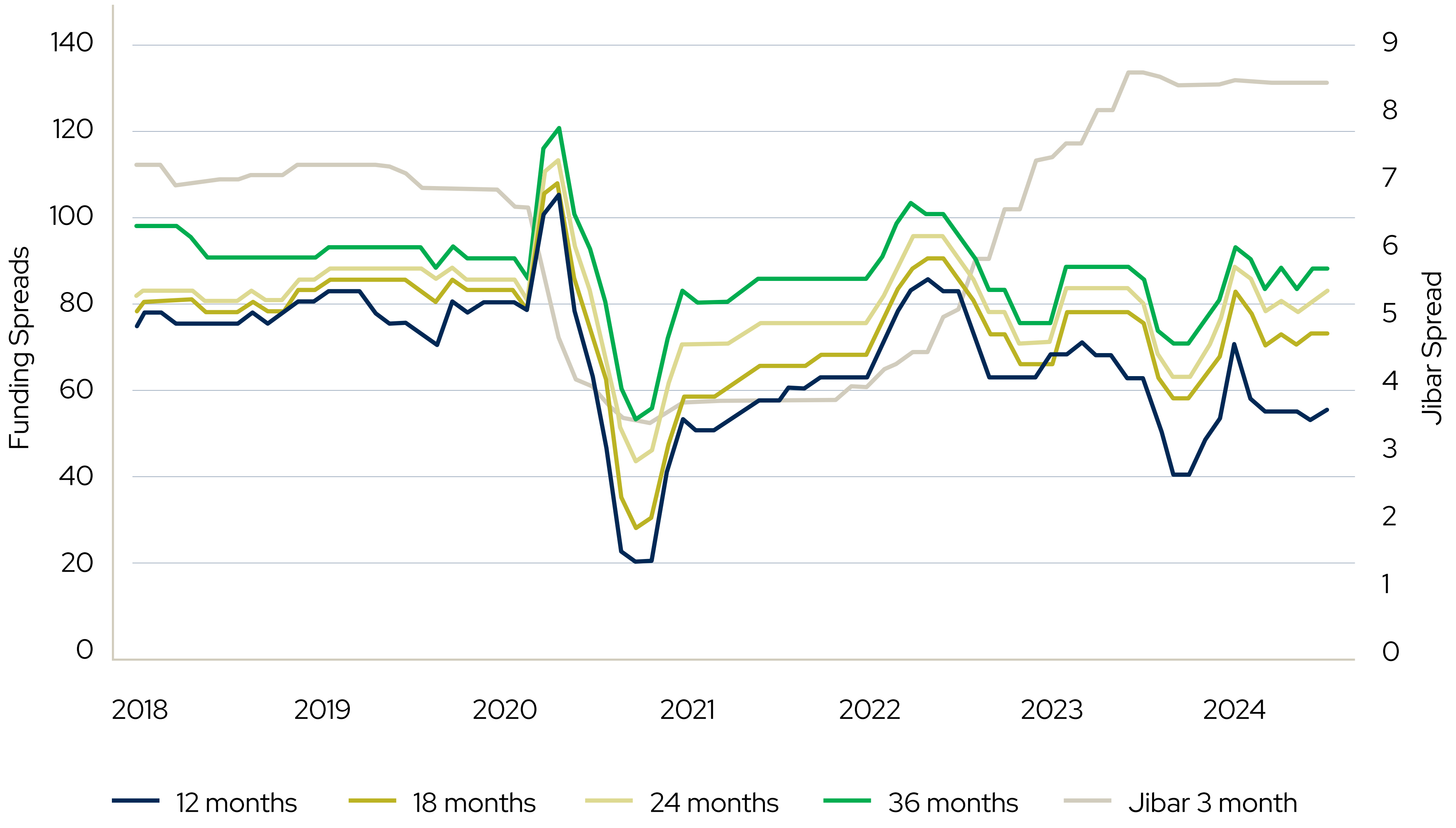
Source: Prescient Investment Management, Bloomberg as on 2024-07-10

> Additionally, a significant risk South Africa faces is that growth has been low for a decade, and the growth outlook remains problematic if systematic inputs such as logistics and energy administrations remain impaired.

Despite its adverse impact on the consumer and the balanced risks to the South African economic outlook, South African investors can anticipate some exceptional opportunities in the middle of the South African yield curve, arising from the elevated real yields. Although the money market yield curve has compressed slightly as local markets finally start to price in three interest rate cuts over the next 12 months, the money market curve remains elevated, keeping cash fund yields at attractive levels. The Prescient Money Market Fund (A2) yield of 9.03% and the Prescient Yield Quant Plus Fund (A2) 9.50% (as of 28 June 2024) show the current elevated real yields offered by cash funds.

When investing in short-term fixed-rate assets of up to 12 months, Treasury Bills trade above Negotiable Certificates of Deposits (NCD). We continue to invest and roll our Step Rate Notes as these reset quarterly while earning an additional pick up in the spread over three-month Jibar. Across the enhanced cash portfolios for investments longer than 12 months, floating rate investments offer value at this point of the curve as three-month Jibar remains elevated compared to the level before the interest rate cutting cycle in 2020, as shown below.

Bank Funding Spreads



Source: Bloomberg (as at 28 June 2024)

Conclusion

Uncertainty has led to a global risk-off trend, including in South Africa. While domestic investors may earn high real rates on the front end of the yield curve now, with dawning rate cuts investors can earn the current high yields in the medium term by locking in fixed rates in the middle of the yield curve now, without incurring undue risks, notwithstanding the pressure from lowering yields. The current high interest rate environment is ideal for the Cash and Income space in South Africa, with yields on Money Market and Enhanced Cash Funds ranging from 9% to 10% and promising opportunities available for investors at the front end of the yield curve.

Capitalising on high yields through the Prescient Global Income Provider Fund

by HENK KOTZE
Head of Cash & Income

Prescient's systematic investment process enables us to make dynamic asset allocation decisions, consistently positioning the fund to maximise returns and minimise risks.

Central banks are still firmly committed to pursuing a data-driven and patient approach to loosening monetary policy to ensure sustained lower inflation. As a result, the front end of the global yield curve is elevated and likely to remain so for some time to come, providing investors with an opportunity to benefit from the historically attractive yields available.

The jury is still out on when the US will deliver its first interest rate cut and what will happen afterwards. September looks likely, but the path for interest rates after that is still uncertain. Against this backdrop, global income funds, like the Prescient Global Income Provider Fund, provide a compelling investment alternative to money market funds.

> The fund's systematic investment approach makes all opportunities across the global Fixed Income universe available to investors, enabling Prescient to compete globally. This is evidenced by the Fund's Morningstar International five-star rating for delivering first-decile performance in a universe of more than 100 global income funds.

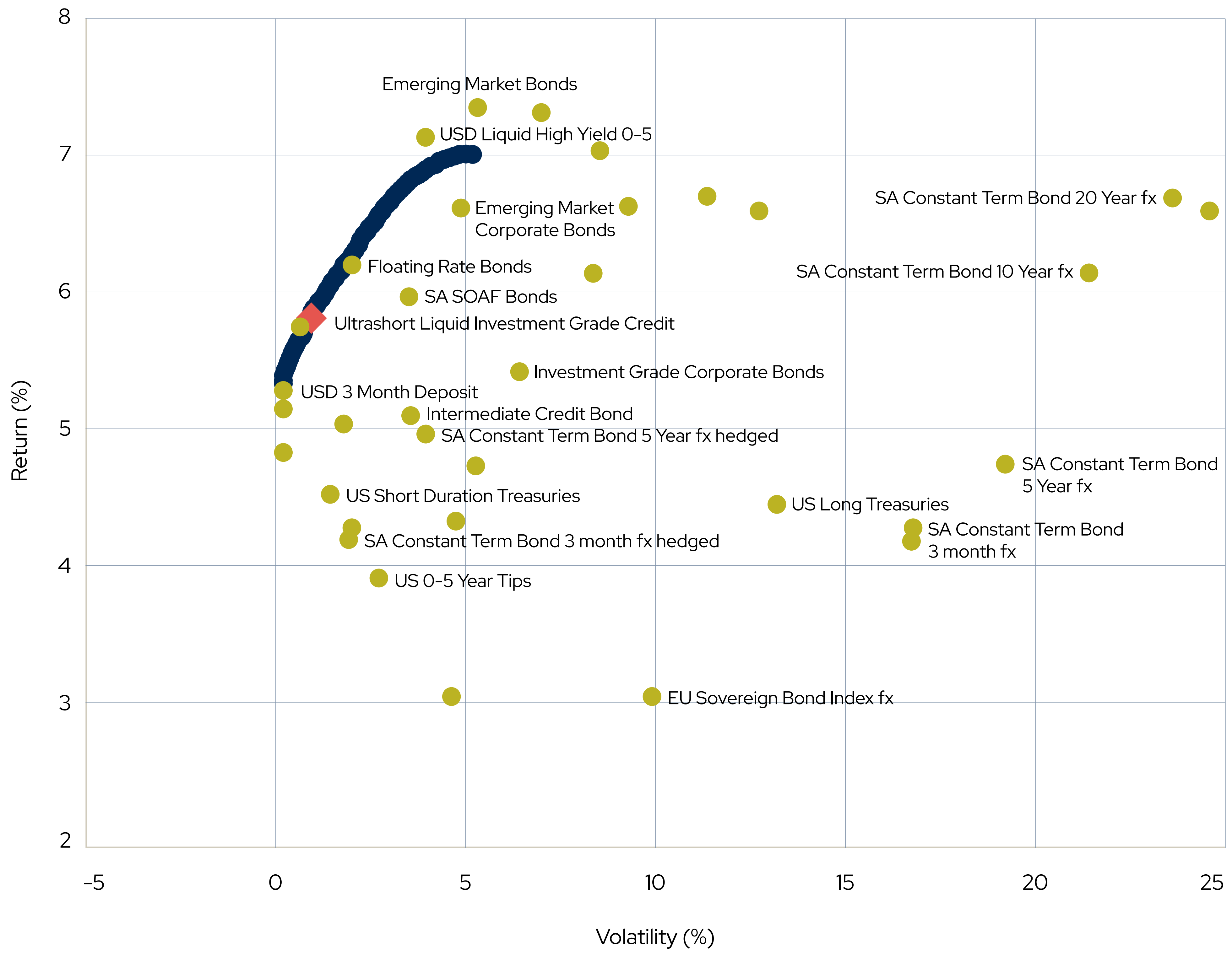
Research has shown that asset allocation is the predominant contributor to a fund's investment performance rather than stock selection, which, in the credit market, would require a large number analysts to monitor a vast universe of companies.

Instead, Prescient's systematic investment process enables it to determine the optimal asset allocation positioning to deliver the best returns at the lowest risk. It then compiles this optimal portfolio by investing in Fixed Income ETFs that diversify exposure across 15 300 different instruments.

Fixed Income instruments at the front end of the yield curve currently offer the greatest potential, and a fund like the Prescient Global Income Provider Fund capitalises on this by following its robust, repeatable, and rigorous investment process, which determines how the fund can best position itself to take advantage of available opportunities.

The first step in the investment process is to build an efficient frontier of all potential optimal portfolios. The frontier represents portfolios that provide the best potential returns at the least amount of risk based on their 12-month expected return and level of risk based on their performance over time.

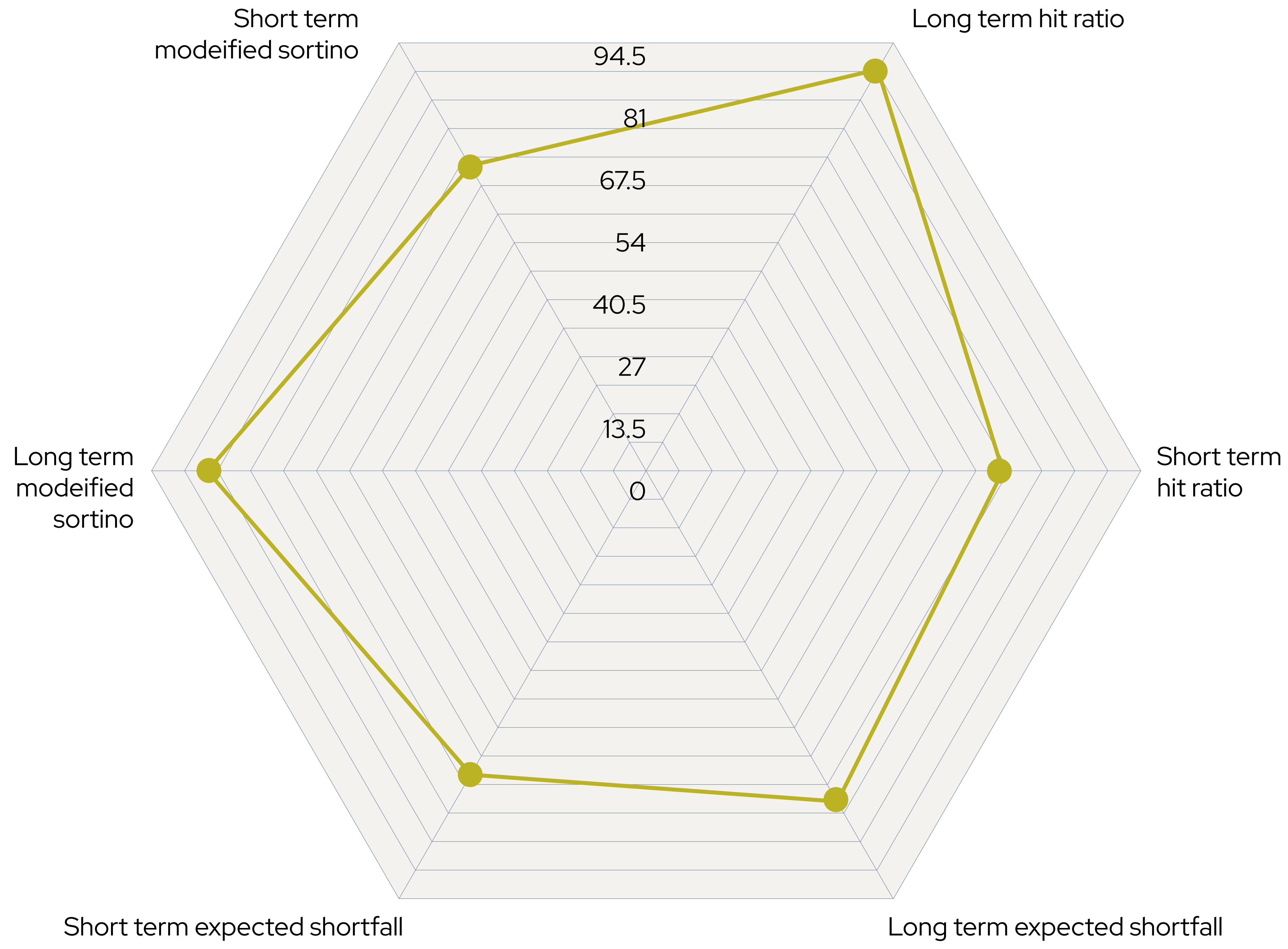
Efficient Frontier Weights



Source: Prescient Investment Management, Bloomberg as on 2024-07-23

Once the efficient frontier of portfolios has been established, we must identify the portfolio most likely to satisfy our key investment objectives: achieving a real return target of US CPI -1.5% and preserving capital over one-year rolling periods. We rely on six criteria to do so, and the results are mapped out on a risk web that illustrates the outcomes. The portfolio covering the most expansive area on the map represents the portfolio that best matches these criteria.

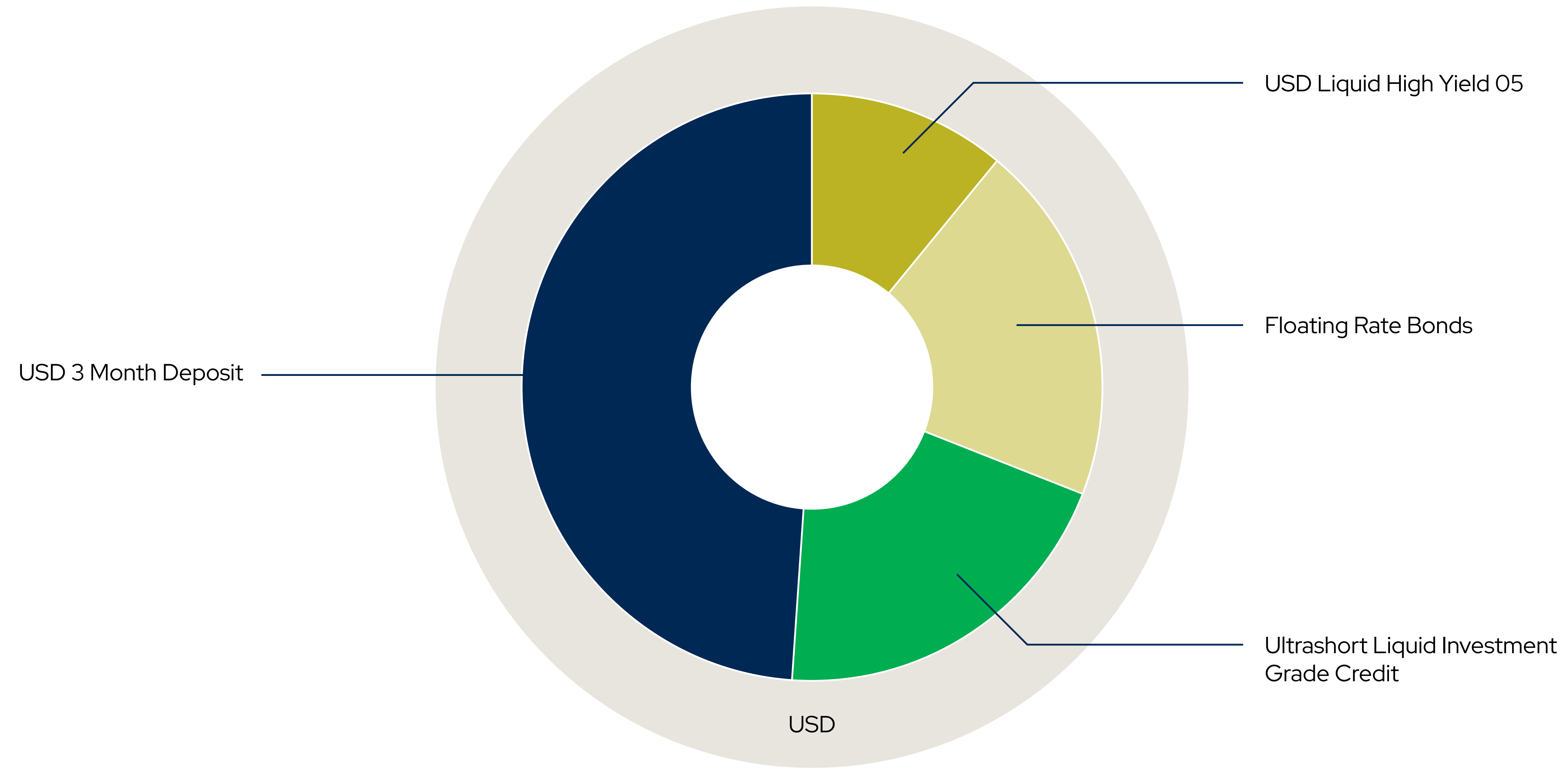
Risk Web



The current optimal portfolio, for instance, has a 0.75 duration (a relatively short duration), is expected to deliver a yield of 6.34% and is invested in conservative, liquid and short-term assets that include three-month money market instruments, USD liquid high-yield assets and floating rate bonds.

While the most attractive global income investment opportunities currently reside at the front end of the curve, this may change if the interest rate outlook changes and central banks surprise the market by either reducing interest rates more aggressively than expected or keeping rates unchanged for an extended time. In this event, Prescient's systematic investment process enables us to make dynamic asset allocation decisions, consistently positioning the fund to maximise returns and minimise risks across the global income asset class.

Strategic Asset Allocation: Optimal Portfolio



Questions you should ask a systematic investor before deciding to invest

by ZUBAIR PATEL
Head of Data Science

What are the crucial questions investors must ask when assessing a systematic investor, the extent of its data capabilities, and the technology and system it uses to get the most out of the information?

Systematic investing has rightfully earned its place in the world of global investment. It is an investment proposition that sits between two approaches on each end of the investment scale: passive and active investing. It offers investors the best of both worlds, including performance ahead of the market and at a cost-effective fee. However, investors need to do their homework to benefit fully from this innovative, data-centric investment approach—and it all starts with the data.

Thus, what are the crucial questions investors must ask when assessing a systematic investor, the extent of its data capabilities, and the technology and system it uses to get the most out of the information?

Does the manager have access to a sufficiently deep and broad data pool that considers everything?

> A sophisticated data-centric system is at the heart of Prescient's systematic investment process. The sheer scale of the investment process necessitates a bespoke analytics platform capable of processing more than 500 million data points, 100 000 time series, and 10 000 instruments. Collectively, this enables swift research in response to market movements and facilitates a collaborative and transparent environment.

As data definition evolves, we recognise the need for more than just numerical, well-structured tabular data processing capabilities. Data is increasingly sourced from alternative sources, including documents, articles, and websites. To extract useful information from these new diverse data streams, Prescient invests in building digital infrastructure and skill sets to process this information.

Does the manager have sufficiently sophisticated data architecture to extract forward-looking insights?

The buzz around AI has sparked excitement, particularly in natural language processing, where machines can now generate articles, answer complex questions, and assist with coding. However, what's truly remarkable is not just the ability to generate these responses but the underlying methods that have been mastered to make this possible. Concepts such as word embeddings, vector databases, and similarity distances have been around for years, but their power has recently been fully harnessed. We can extract valuable insights by re-evaluating our existing datasets and applying new data processing methods.

Prescient's system is not a simple off-the-shelf solution. Instead, each system component is researched, stress tested, and evaluated against competing technologies, and a long-term use case is established in the overall system architecture. System architecture is no new field; many Silicon Valley companies have innovated in data architecture design. Take Netflix, for example. The streaming giant's architecture is discussed in numerous articles.

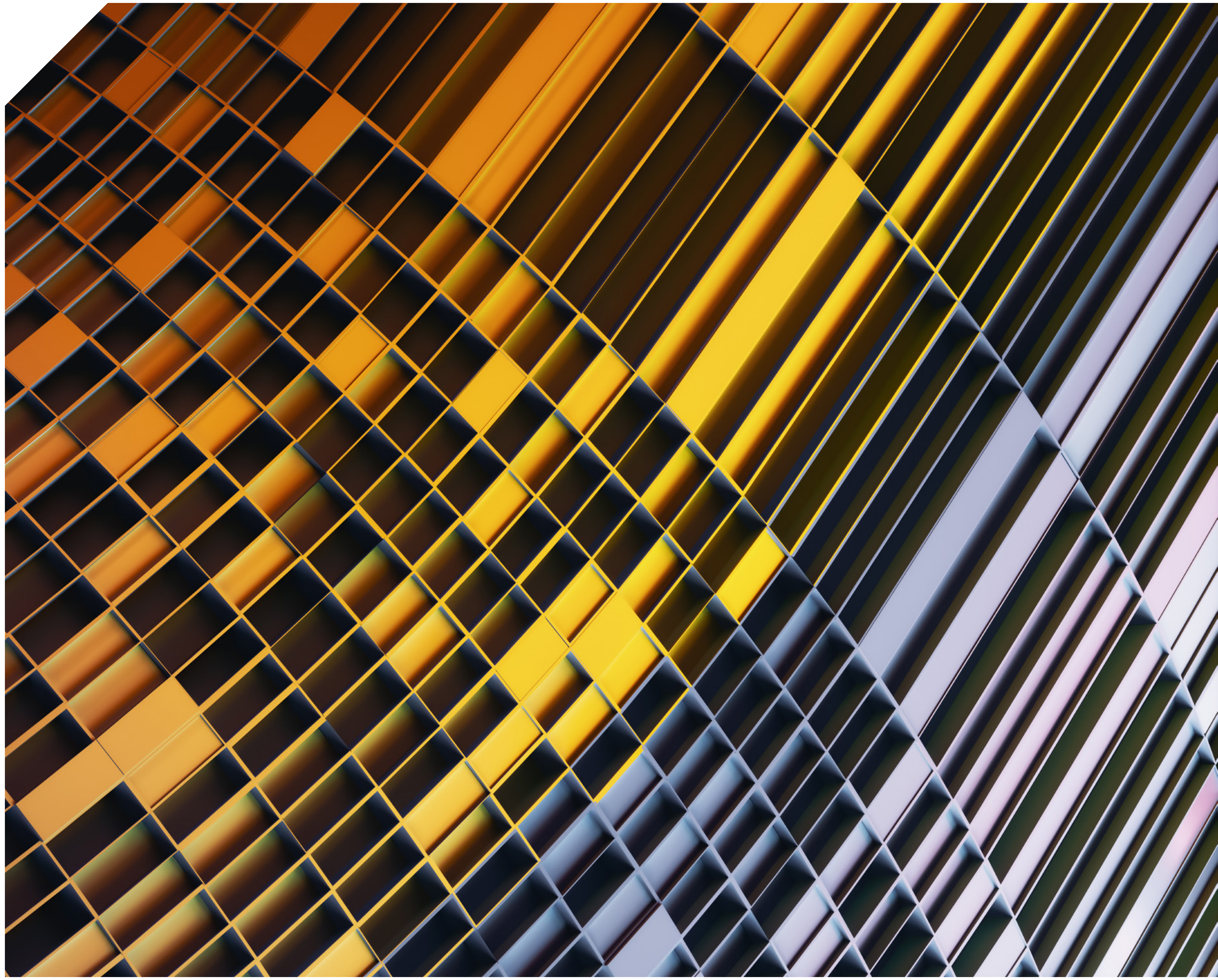
To be at the forefront of data processing, you must look at industry leaders... and then some. The investment team delves deep into software development to run its investment process, adopting best practices from established tech companies to scale its data processing capabilities.

Developing in-house and adopting industry standards may seem an unnecessary initial step for an investment house. However, the benefits of doing the groundwork are compounded by the ability to modify architecture to accommodate changing data and processing requirements. Conveniently, the tech space is a thriving and innovative environment that allows us to continuously test new technologies in our system.

What else do investors need to consider?

An investment manager's data capabilities form the foundation of its investment offering. Other must-haves when considering a systematic investor include a robust, agile, and repeatable investment process that will stand the test of time and deliver the needed returns.

> The key differentiator between passive and systematic investors is also that the latter combines data science and human oversight. Thus, the manager should have an investment team with the expertise required to sanity check the data, assess the insights generated by the data and make investment decisions. By considering all these elements that determine a systematic investment manager's success, investors ensure they maximise the many benefits of what systematic investment offers.



Prescient flagship funds

Prescient Income Provider

Income producing with downside risk managed while offering inflation protection.

FIND OUT MORE

Real: CPI + 1% p.a.
Horizon: 3+ months

Prescient Income Plus Fund

High yield via credit exposure with inflation protection.

FIND OUT MORE

Real: CPI + 3% p.a.
Horizon: 3+ months

Prescient Defensive Fund

Savings for retirement and other goals offering a more conservative asset allocation including equities and offshore assets.

FIND OUT MORE

Real: CPI + 4% p.a.
Horizon: 3+ years

Prescient Balanced Fund

Long term savings for retirement offering an aggressive asset allocation to mostly equities and offshore assets.

FIND OUT MORE

Real: CPI + 6% p.a.
Horizon: 5+ years

Prescient Equity Fund

Long term savings aiming to consistently outperform peers.

FIND OUT MORE

Real: CPI + 7% p.a.
Horizon: 5+ years

Prescient offshore flagship funds

Prescient Global Income Provider Fund

Diversified Global Income exposure within a well maintained risk framework.

FIND OUT MORE

Real: CPI + 1% p.a.
Horizon: 3+ months

Prescient Global Balanced Fund

diversified exposure to a mix of offshore assets with an aim to achieve long term capital growth appreciation.

FIND OUT MORE

Real: CPI + 5% p.a.
Horizon: 5+ years

Prescient Core Global Equity Fund

Cost-effective access to diversified global equity markets.

FIND OUT MORE

Real: US CPI + 6% p.a.
Horizon: 7+ years

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