QUARTERLY COMMENTARY

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Prescient on point.

Prescient

INVESTMENT MANAGEMENT

In this issue

Preparation and a systematic investment approach trump market predictions

A NOTE FROM OUR CEO

by **CHEREE DYERS**
Chief Executive Officer

"If you have an opinion about the level of prices, it should be an opinion based upon your concept of the values of securities in relation to price, rather than on any prophecy or expectation of changes or of the continuance of a given moment."

– Benjamin Graham

Volatility and uncertainty have predominated since the pandemic, making forecasting the future even more challenging. However, many investment giants have highlighted the importance of relying on a robust and repeatable investment approach that enables you to determine the value of what you buy instead of predicting its worth.

> One of the greatest minds in investing, Benjamin Graham sums it up best: "If you have an opinion about the level of prices, it should be an opinion based upon your concept of the values of securities in relation to price, rather than on any prophecy or expectation of changes or of the continuance of a given moment."

This wisdom underpins our systematic investment philosophy at Prescient, where we make asset allocation decisions based on rational, data-driven insights that ensure we know what we are doing.

In our latest edition of On Point, our investment team delves deeper into the trends and developments shaping the investment landscape, offering our perspectives on how these factors may influence portfolio construction and performance in the coming months.

Global equity markets demonstrated resilience, posting robust returns despite periods of turbulence. Developed market equities gained 6.5% over the quarter, while the FTSE/JSE All Share Index climbed an impressive 9.6%. This rebound signals renewed investor confidence, particularly in light of shifting monetary policies worldwide.

A pivotal moment came with the US Federal Reserve's decision to begin its interest rate-cutting cycle in September, following 14 months of steady rates. This move, prompted by signs of economic softening, including a rise in unemployment from 3.4% in April 2023 to 4.2% by September 2024, marks a significant shift in the global monetary landscape. The Fed's more accommodative stance, coupled with China's new stimulus measures and Japan's less aggressive monetary policy, catalysed a substantial rally in global equities as the quarter drew to a close.

The prospect of more interest rate cuts bolstered fixed-income markets, with the Barclays Global Aggregate Index recording a 7.0% return. Government bonds, corporate credit, and emerging market debt all posted substantial gains. South Africa's All Bond Index returned an impressive 10.5%, benefiting from improved investor sentiment and the global shift toward more accommodative monetary policies.

Against this backdrop, our multi-asset class team considers why multi-asset portfolio construction trumps stock selection in building a solid investment foundation in this edition of On Point. Meanwhile, our equity team investigates the value of downside risk management in buoyant equity markets.

The data science and quantitative team also explores how data science is reshaping the investment landscape by offering powerful tools to enhance decision-making and performance.

Then, our Cash and Income team analyses a significant change on the horizon for South African financial markets: the impending transition from the Johannesburg Interbank Average Rate (JIBAR) to the South African Rand Overnight Index Average (ZARONIA) as the primary reference rate.

> At Prescient Investment Management, our focus is on delivering consistent investment returns remains unwavering as we navigate the complexities of today's financial markets, from global economic shifts to fundamental changes in financial benchmarks. As always, we aim to provide you with the insights that enable you to make informed investment decisions in an ever-changing world.

Volatility and growth

A LOOKBACK ON THE PAST QUARTER

by **BASTIAN TEICHGREEBER**
Chief Investment Officer

"The most important thing is to be aware of what you don't know."

– Howard Marks

The third quarter of 2024 closed on a positive note for most major asset classes despite enduring several periods of significant market volatility. Financial markets navigated through an eventful quarter, with disruptions caused by weaker-than-expected US economic data, the Bank of Japan's interest rate hike, and lower-than-usual liquidity.

These factors initially sent shockwaves through global stock markets in early August, but a rally toward the end of the quarter signalled renewed investor optimism. Howard Marks wisely observed, "You can't predict, but you can prepare." This sentiment aligns closely with Prescient's systematic investment philosophy, which emphasises risk management as the cornerstone of long-term success. In navigating a volatile environment, we prioritise asset allocation and diversification to buffer against unpredictable market forces.

US Federal Reserve: Shifting Course on Interest Rates

One of the most anticipated third-quarter events this year was the Federal Reserve's September decision to begin its interest rate-cutting cycle. After 14 months of holding rates steady, the Fed opted for a 50-basis point reduction.

The Fed's decision followed signs of the US economy weakening, including a rising unemployment rate, which increased from 3.4% in April 2023 to 4.2% by September 2024. With this shift, it became clear that the Fed intended to prevent further economic deterioration and support growth by reducing the restrictiveness of monetary policy.

The Fed's softer tone in September, combined with China's new stimulus measures and Japan's less aggressive monetary policy stance, prompted a market rebound. This, in turn, spurred a substantial rally in global equities in the lead-up to the quarter's end.

Equity Market Performance: A Healthy Recovery

Despite the volatility experienced in August, global equity markets ended the third quarter with robust returns. Developed market equities posted a 6.5% gain over the quarter. The rebound in equities demonstrates renewed confidence in risk assets as investors positioned themselves to benefit from potentially lower interest rates in the future.

> While volatility is inevitable, Prescient's focus on implementing systematic investment strategies that prioritise asset allocation ensures that portfolios are well-prepared to handle the ups and downs of market cycles while still capitalising on growth opportunities.

Fixed Income: Positive Prospects Amid Lower Rates

The prospect of a more accommodative interest rate environment favoured fixed-income markets during the third quarter. The Barclays Global Aggregate Index, a benchmark for global fixed income, recorded a 7.0% return over the period. Government bonds, corporate credit, and emerging market debt all posted substantial gains, with emerging market debt rallying by 6.1%.

Commodities Movements

In contrast to the stellar performance of equities and fixed income, commodity markets delivered more muted results in the third quarter of 2024, with the sector posting just a 0.7% gain. Brent crude oil prices fell sharply, down 17%, as global economic concerns weighed heavily on demand projections. However, gold prices surged to new all-time highs, reflecting its traditional role as a safe-haven asset during periods of uncertainty.

Bringing it Back Home: South Africa

South African financial markets experienced a strong recovery during the quarter. The All-Share Index climbed 9.6%, while the All-Bond Index returned 10.5%. The South African rand appreciated 5.4% against the US dollar, benefiting from improved investor sentiment and the global shift toward more accommodative monetary policies.

Prescient's Systematic Approach to Investment

At Prescient, our systematic investment process is designed to thrive in both volatile and stable market conditions. We understand that uncertainty is a constant in financial markets, but we also know that volatility presents opportunities.

Our focus on asset allocation and risk management allows us to tailor Global Investment Funds to meet various investment goals and risk tolerances. Whether our clients seek stable income, long-term growth, or exposure to specific markets, our funds are structured to optimise returns while minimising risk.

Prescient's approach aligns with the financial community's long-standing belief that risk management is the key to success. As Howard Marks puts it, "The most important thing is to be aware of what you don't know."

By acknowledging the inherent unpredictability of markets and maintaining a disciplined, systematic approach to asset allocation, we ensure that our portfolios are well-positioned to weather uncertainties and capitalise on opportunities when they arise.

Source: Bloomberg, 30 September 2024

Getting the foundations right in multi-asset portfolios

THE IMPORTANCE OF ASSET ALLOCATION VERSUS STOCK SELECTION

by **RUPERT HARE**
Head of Multi-Asset

and **SHRIYA ROY**
Quantitative Analyst

We see asset classes as the bedrock on which to build portfolios, with the underlying holdings as the sand around them.

A well-told biblical story compares the wise man who built his house on a rock, enabling it to withstand winds and floods, with the foolish man who built his house in the sand and whose house was swept away in the floods. The same is true in multi-asset funds, although this truth is often underappreciated and swept away by a fixation on single stock narratives.

When speaking with clients about how we run multi-asset solutions, the question often arises: Where do you even start? Prescient always begins at the asset class level; we build a solid foundation that aligns with the client's objectives and then take shorter-term measured tilts away from that foundation. We don't take a combination of views (read "narratives") around single stocks or bonds and build the portfolios from the bottom up. There's a reason for that, and it goes back to the analogy of the man who built his house on the rock. We see asset classes as the bedrock on which to build portfolios, with the underlying holdings as the sand around them.

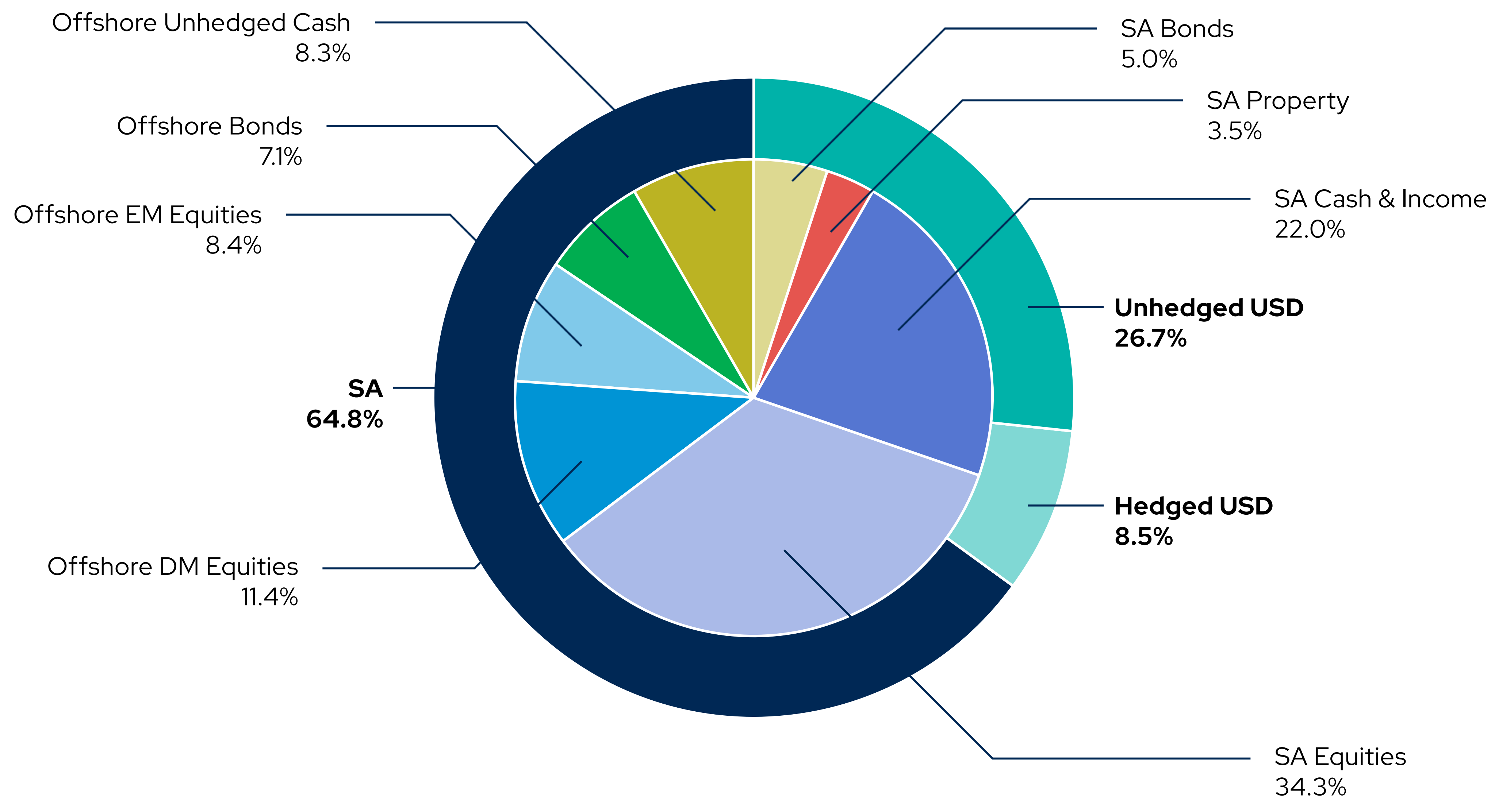
Here are a few examples of why building a strong multi-asset class foundation makes (almost) all the difference:

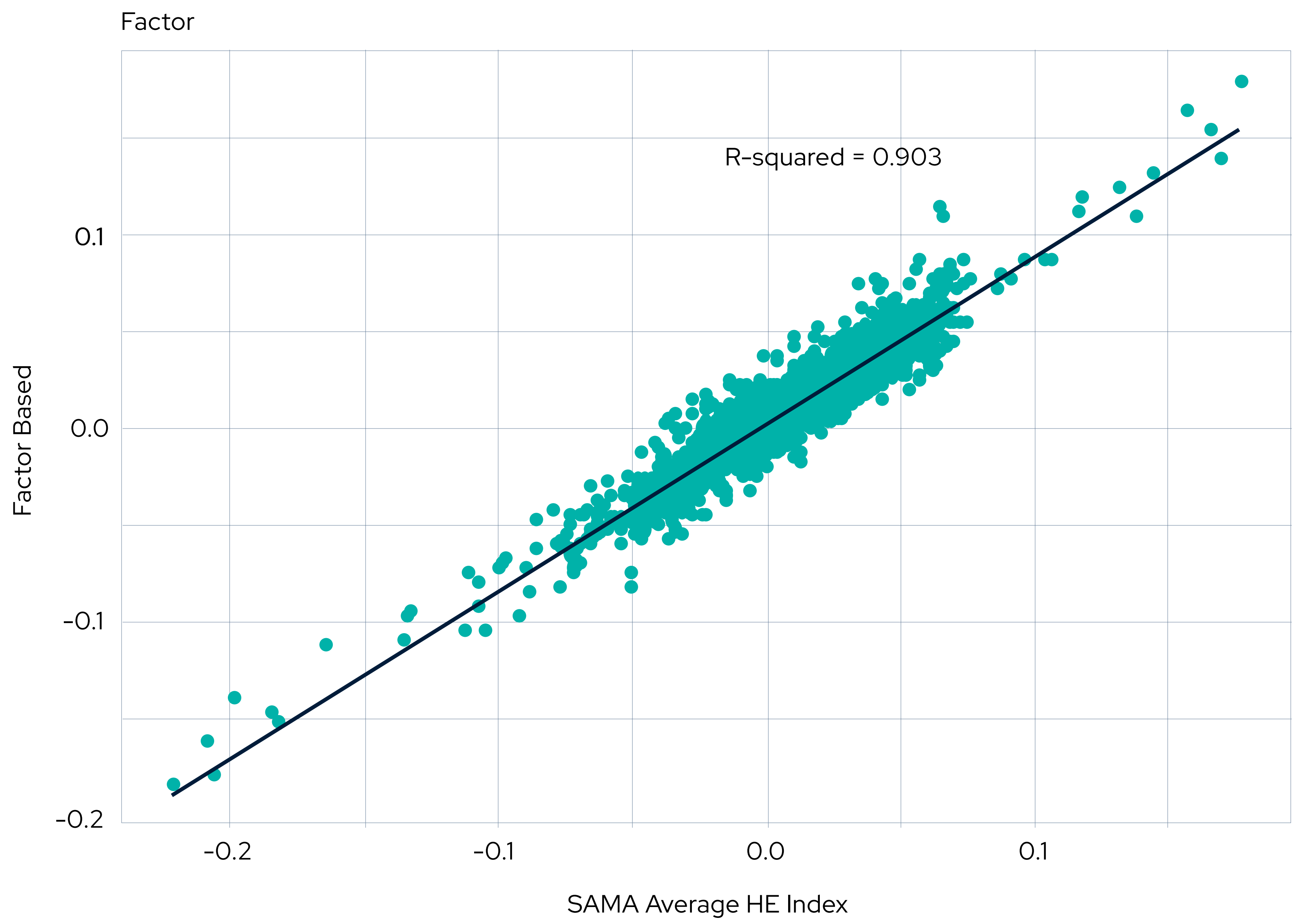
A perennial study aptly titled Determinants of Portfolio Performance was first written in 1986 by the trio of Brinson, Hood and Beebower. It attributed 96% of multi-asset portfolio performance in the US to long-term asset allocation and the 4% remainder to market timing and security selection. The study was repeated in several forms in the decades after with similar results. In other words - picking a 60/40 portfolio instead of an 80/20 portfolio made a much more significant difference than picking 1% more shares in Apple than the index.

Similar to the formative 1986 study, Prescient's models, drawing on the returns of the ASISA Multi Asset High Equity category, can explain 90.3% of the variance in the portfolios using generic asset classes (equities, bonds, offshore, onshore etc). And in perhaps a somewhat Orwellian setup, we track every peer in every peer group daily, getting insights into what drives portfolio performance in real-time. Perhaps it may come as a surprise, but what you see on factsheets often isn't what you get in practice when it comes to performance attribution, a factsheet that shows 45% SA equities may actually be a fund giving you something closer to 30% SA equities and 15% broader Emerging Market equities.

> What that means for you as investors is that the single stock narratives in your manager reportbacks should be an afterthought, and the asset class allocations should be the main event.

Using our ASISA High Equity peer group returns models at the end of September 2024, we can derive the below asset class mix with over 90% accuracy around their current aggregate allocation.





Let's take the South African market as a practical example. The JSE has 40 larger companies (known as the Top40). These stocks are reasonably liquid and supposedly diversified, although by global standards, thoroughly concentrated.

An active stock-picking multi-asset portfolio might invest in 20 of those stocks and allocate 40% to the asset class overall. That means, on average, the stocks will each get a 2% weight in the overall portfolio. Some stocks may do better than others and among themselves and are seemingly uncorrelated. However, their correlation as a portfolio of stocks remains high relative to the overall market, ironically even more so when the portfolio is diversified away from single-name risk.

Now, mix that with the government bond market, where all SA bonds are on one yield curve. This means any parallel shifts in the yield curve (the primary driver of bond returns) are felt by all bonds, thus making all SA bonds highly correlated to the ALBI Index. Then, consider the correlation between the JSE Top40 and the ALBI Index, or even more so, the S&P500 Index and the US Government Bond Index. You'll find a much higher degree of difference – sometimes even negative correlations.

What that means is that asset managers' most important decision isn't so much which stocks or bonds to buy as how much to allocate to stocks or bonds as a whole. So, when you are next in a manager report back or a fund pitch and you get told yet another fantastic story about how a single stock in a portfolio that only makes up 2% of the whole is (seemingly without doubt) going to reach a target price of R1.20/share, perhaps interrupt them and ask the portfolio manager to instead talk about what the best mix of concrete to build a solid foundation (1 part cement, 1 part sand, 2 parts stone chips for those interested) and why that analogy aligns well with building multi-asset strategies that are robust enough to withstand the floods and align to your investment objectives.

> At Prescient, that's our first port of call: building portfolios to maximise the likelihood of meeting client objectives with the asset class mixes that are most likely to deliver the same results as the house built on rock rather than sand.

I am readily available when unnecessary but vanish when needed. What am I?

by **SEEISO MATLANYANE**
Head of Equities

and **NICHOLAS DE CLERCQ**
Quantitative Analyst

> In this extremely positive market environment, the downside risk management benefits are seemingly unnecessary.

You might be forgiven for guessing that the answer is an umbrella or perhaps even a pen; however, given the recent strength of equity markets, we discovered a similarly applicable yet unintuitive answer, which will hopefully become apparent soon.

Broadly speaking, equity markets have been solid, the MSCI World, MSCI Emerging Markets, and the FTSE/JSE All Share indices all reached their highest levels at some point during this past quarter. Over the past year, they have respectively gained a remarkable 32%, 26%, and 24%.

In this extremely positive market environment, the downside risk management benefits are seemingly unnecessary. In a 1993 letter to shareholders, Warren Buffett is famously paraphrased as having characterised diversification as a form of protection against ignorance, which made little sense to informed investors. It is difficult to fault that logic; concentrated high-conviction positions should ostensibly be expected to outperform a potentially diluted, wider-breadth investment set in bullish markets.

> The true benefits of diversification are, therefore, most needed during severe market downturns, when the defensive and less correlated nature of certain sectors or shares can be useful in cushioning the fallout from those in the direct line of fire. What we find, however is that, like an umbrella or a pen, this critical attribute tends to grow scarcer when most in need.

We quantitatively evaluated the potential for meaningful diversification in the FTSE/JSE All Share universe using Principal Component Analysis (PCA). Breaking down the various equity sector returns into their first principal

Rolling 252-Period PCA: Explained Variance Ratio of PC1

Source: Prescient Investment Management, Bloomberg as of Sep 2024

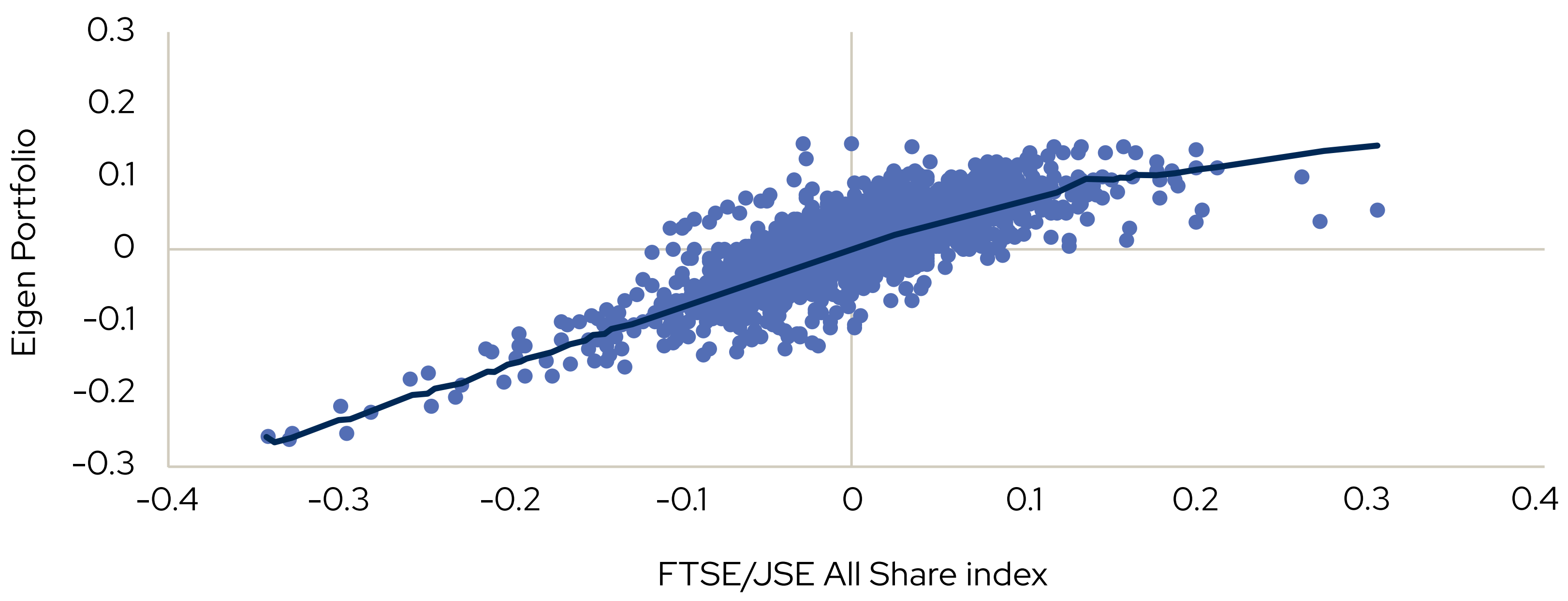
component (PC1) allows us to assess how much of the market variation is explained by similar characteristics. The higher the variance explained by PC1, the more the various sector returns act in a similar way and the lower the potential for diversification in a long-only portfolio.

The chart above illustrates how the explained variance of this PC1 has changed over time, and there is a slight downward trend, suggesting that the potential for diversification has increased as the market has risen. Interestingly, the explained variance is elevated during market drawdowns such as the Covid pandemic crash in 2020. This is consistent with other empirical findings of increased correlations during market crashes. While the rise in correlations (and the reduced effectiveness of diversification) during extreme markets has been well-documented, the numbers show that this effect is asymmetric depending on whether the market is bullish or bearish.

Analysing Diversification Potential in Different Market Conditions

Extracting the "Eigen Portfolio" – a portfolio with weights equal to the normalised first eigen vector from the PCA – allows for a comparison of returns between an objectively well-diversified portfolio and the FTSE/JSE All Share index. Essentially, we can illustrate how the diversification benefits of a traditionally well-diversified portfolio (downside protection) dissipate when most needed – during market crashes, while remaining abundantly available when unnecessary – during market rallies.

Monthly Returns of the Eigen Portfolio against FTSE/JSE All Share Index

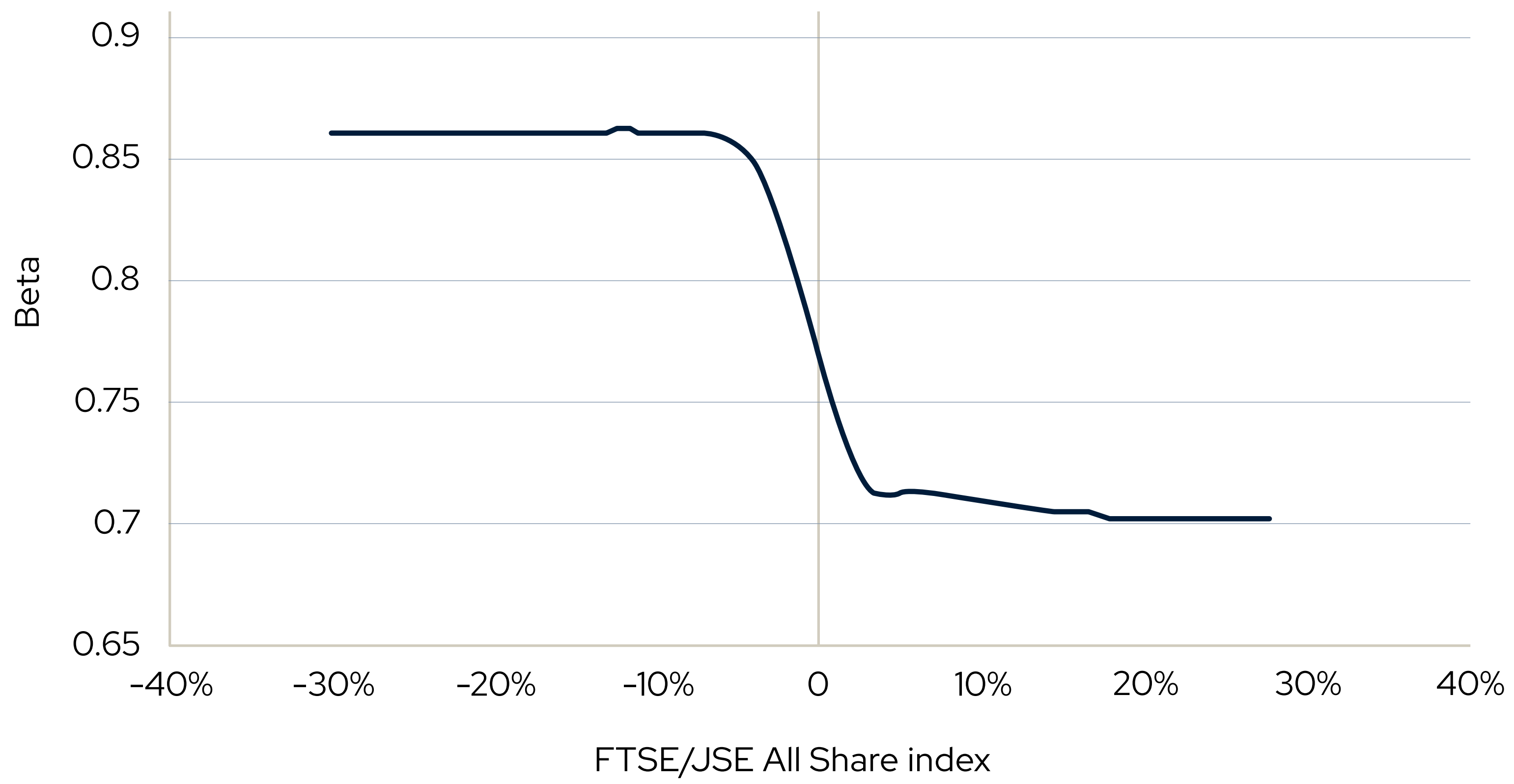


Source: Prescient Investment Management, Bloomberg as of Sep 2024

The chart above clearly shows that returns are highly correlated. However, the extent of this is notably lower in the upper right-hand quadrant as compared to the lower left-hand quadrant. Indicating that this relationship is clearly dependent on the direction of the market. The conditional betas of our Eigen Portfolio to the FTSE/JSE All Share index help illustrate this as depicted below.

These conditional betas do indeed decrease as the returns of the FTSE/JSE All Share Index increase. This is somewhat expected as all shares tend to be highly correlated during market downturns. Unfortunately, it also means that even the most 'diversified' equity portfolios can be left vulnerable to severe drawdowns when markets crash.

Conditional betas

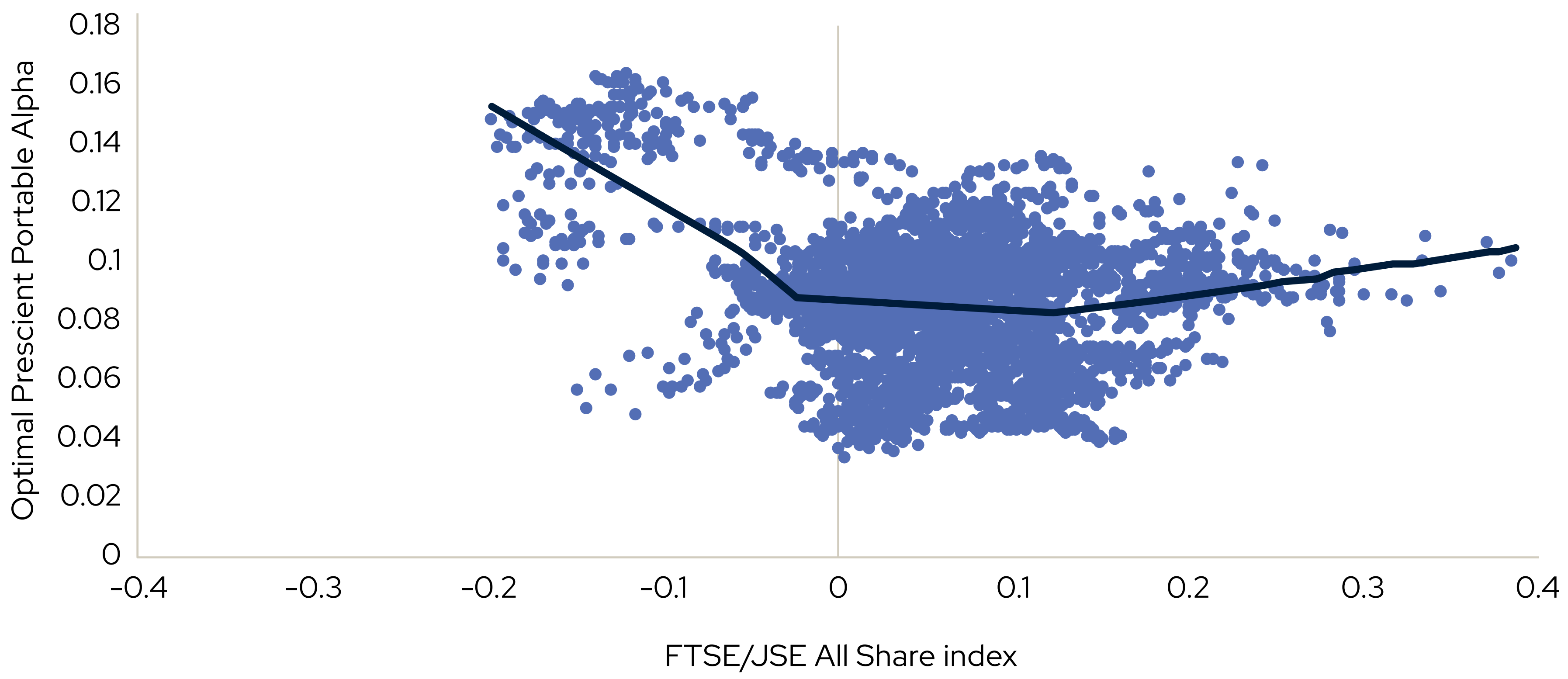


Source: Prescient Investment Management, Bloomberg as of Sep 2024

The Prescient Portable Alpha Solution

One of the reasons we make extensive use of the portable alpha strategy in our equity products is because it provides and elegant solution to this dilemma by allowing us to achieve true diversification. Utilising an uncorrelated source of performance from the cash and fixed-income asset classes is vital to providing meaningful protection for the portfolios. This benefit can be demonstrated using this same framework by simply substituting our optimal portable alpha returns in place of the Eigen Portfolio.

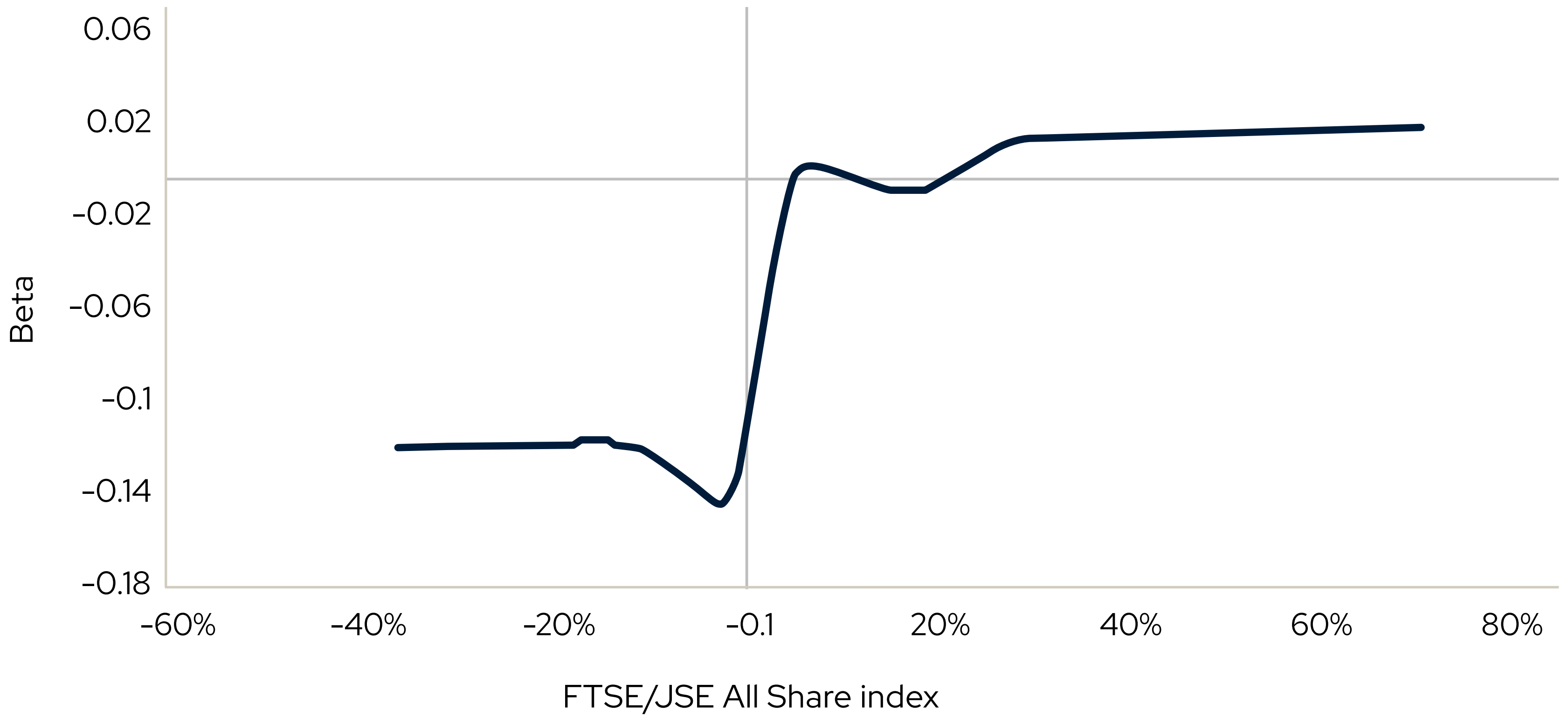
Annual Returns of the Portable Alpha Portfolio against FTSE/JSE All Share Index



Source: Prescient Investment Management, Bloomberg as of Sep 2024

In the figure above, we have plotted the returns of the portable alpha portfolio against the returns of the underlying equity market. As we can see, the profile significantly changes to a “smile,” which means that the portable alpha portfolio achieves positive returns in years when the equity portfolio realises negative returns.

Conditional betas using portable alpha



Source: Prescient Investment Management, Bloomberg as of Sep 2024

Finally, the figure above shows the beta coefficients and in contrast to earlier (where we plot market vs. eigen portfolio), we can see that the betas trend upwards, which suggests that we achieve meaningful diversification in times of market downtrends as well as in times of market uptrends.

Prescient Portable Alpha Bond Fund offering

by REZA ISMAIL
Head of Bonds

The foundation of portable alpha lies in the separation of “alpha” and “beta” components, enabling investors to achieve market returns through managed beta exposure while simultaneously pursuing alpha generation.

Portable alpha investment strategies emerged in the late 1980’s and early 1990’s as an innovation within institutional portfolio management, driven by the increasing demand for investment approaches that could generate excess returns, or “alpha,” independent of market-related risk exposures, generally referred to as “beta.” Strictly speaking, alpha is the return that is not explained by the beta-adjusted return.

The conceptual foundation of portable alpha lies therefore in the separation of these “alpha” and “beta” components, enabling investors to achieve market returns through managed beta exposure while simultaneously pursuing alpha generation through alternative, and preferably uncorrelated investment strategies.

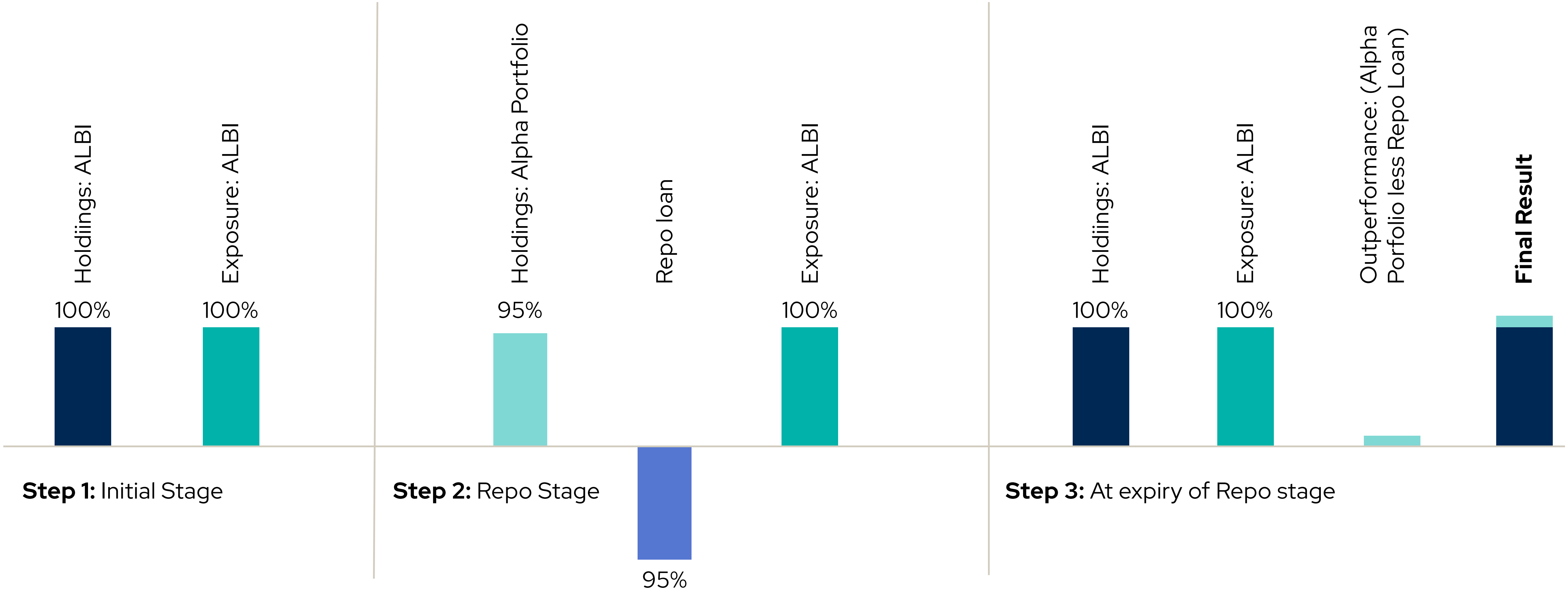
This bifurcation allowed for greater flexibility and diversification in portfolio construction, aligning with modern portfolio theory’s emphasis on uncorrelated return sources to optimize risk-adjusted returns. The development of portable alpha strategies coincided with advancements in financial derivatives, particularly the proliferation of futures contracts, swaps, and repo strategies which provided mechanisms for efficient beta management.

Prescient Investment Management has for a long time employed portable alpha strategies in certain of our fund propositions wherein the base assumptions for price formation in the asset market relate to the strong forms of market efficiency. If an asset market is void of opportunities to harvest alpha in a scalable, repeatable and coherent fashion – for Prescient Investment Management, the South African equity space is such an example – then the best course of action would be to replicate the entire market (i.e. buy beta) as cheaply and efficiently as possible, whilst harvesting alpha from an uncorrelated source. This is precisely the mechanism we have employed in our equity offerings for more than a decade.

With regard to the South African fixed income space, our historical assessment has been that there are indeed opportunities to harvest alpha via tactical decisions relating to predicted changes in the level, slope and curvature of the South African term structure of rates, along with circumspect instrument selection in credit markets. The decision to introduce a portable alpha proposition within the SA Bond space therefore does not relate to the absence of harvestable alpha in the fixed income market, but rather to offer an alternative product for investors seeking an SA bond return profile that minimises benchmark-relative risk, while delivering a stable and predictable alpha profile from uncorrelated sources.

The Prescient Portable Alpha Bond Fund provides systematic exposure to the All-Bond (ALBI) Index (beta component) whilst also offering exposure to an optimised alpha portfolio that aims to produce an additional 1.0% before fees. The alpha portfolio has been systematically optimised across various risk metrics including tracking-error, expected shortfall, and generates a low-volatility income-asset-like portfolio that has the highest statistical likelihood of outperforming the associated funding costs of the strategy.

Basic Bond Portable Alpha mechanism



Source: Prescient Investment Management, October 2024

Another motivation for the SA portable alpha bond proposition is purely empirical: examining typical ALBI-cognisant manager performance survey tables reveals several, generaliasable characteristics of the data, which helps to position the product.

The first is that the annualised return dispersion among SA bond managers generally decreases as the measurement period increases. That is, very simply, the average deviation from the overall survey mean decreases as the measurement period increases.

Secondly, the quantum of annualised outperformance from a given index (in this case the ALBI), tends to be fairly pedestrian as the measurement period increases. By way of example, looking at 10-year SA nominal bond performance tables reveal that in order to rank in the 90th percentile of outperformance, an SA bond manager would only need to have an annualised outperformance of 40bps over the ALBI net of fees.

Combining these observations, over the long-term one could say that SA bond returns between managers start to look remarkably similar, and the annualised quantum of alpha (relative to the ALBI) for even the very best of these managers is not particularly sizeable. If one could therefore manufacture an SA bond performance profile of ALBI+1.0% p.a. before fees in every calendar year, this would automatically see such a proposition drift towards the very top of performance survey tables as the measurement period moves beyond the initial (noisy) few years.

Aside from the projected competitiveness on the basis of the arguments above, the segment of the market which the Prescient Portable Alpha Bond Fund would emphatically like to target is the purely passive ALBI-tracker space. If one accepts that the best possible outcome a pure ALBI-tracker could ostensibly deliver is the underperformance of ALBI each year by the quantum of manager fees, then a proposition that offers ALBI + 1.0% before fees each year with extremely high predictability and very low tracking-error, becomes extremely compelling for investors in that space.

The performance of a portable alpha process is by construction highly path-dependent, and notwithstanding its conceptual simplicity, there are several obstacles that could potentially derail the strategy. It is fair to say that the strategy relies heavily on several inter-connected cogs working in well-synchronised fashion in order to keep the overall machine moving appropriately.

Some of these obstacles relate to having the requisite liquidity in both the "beta" and "alpha" segments, being cognisant of market bid/offer spreads and carefully curating the alpha portfolio with genuinely uncorrelated exposures to the beta segment. What may look like an attractively engineered solution conceptually, may of course not work in practice, and having deep experience in the idiosyncrasies of fixed income markets certainly helps to bridge these disconnects from time to time. We note also that the alpha portfolio is typically "funded", and this means that "unfunded" (synthetic formats) will be needed elsewhere, such as the ability to short beta through futures or repo transactions. A thorough understanding of the mechanics around taking synthetic exposure is critical for the overall success of the proposition.

> Prescient Investment Management, given our systematic expertise and strong legacy in fixed income markets is in many respects the ideal manager for effecting SA Bond portable alpha strategies. Whilst the overall ideas around portable alpha investment strategies are not very conceptually taxing, they nonetheless require expertise at every facet of the process, and very importantly, the overall success of the proposition depends heavily on the robustness around the construction of the alpha portfolio.

Considering credit quality and risk premia

by CONWAY WILLIAMS
Head of Credit

Credit quality, or the assessment of an issuer's ability to meet its debt obligations, is the cornerstone of fixed-income investing.

Credit quality and risk premia are critical considerations for fixed-income investors in an increasingly uncertain global environment and a South African economy marked by volatility and structural challenges. As South Africa's leading systematic asset manager, we continue to witness first-hand how these factors influence decision-making across portfolios, particularly in the current economic uncertainty and market volatility environment.

Credit quality, or the assessment of an issuer's ability to meet its debt obligations, is the cornerstone of fixed-income investing. When we evaluate investment opportunities, we analyse the issuer's underlying strength—its performance, balance sheet, cashflows, the state of the industry it operates in, and, importantly, the broader economic outlook.

At Prescient Investment Management, credit analysis forms the foundation of our investment process. We deploy a systematic, data-driven approach to ensure we accurately assess creditworthiness, leveraging traditional financial metrics and advanced quantitative models.

This approach becomes even more critical with South Africa's unique political and economic factors. In a world of increasing global uncertainty—whether due to inflationary pressures, geopolitical tensions, or local economic challenges—ascertaining credit quality cannot be compromised. Investment-grade credit has become a key area of focus as we seek bonds that provide stability and predictable returns, even when yields are compressed.

Our model-driven strategies help us distinguish between issuers that may face temporary liquidity issues and those that present long-term default risk. While credit quality is primarily concerned with minimising default risk, risk premia represent the additional compensation investors demand for assuming greater risk. In fixed-income markets, risk premia materialise through yield spreads—the difference between the yield on a corporate bond and a risk-free government bond. The higher the risk of default or volatility in an issuer's credit profile, the wider the spread investors require to justify taking on that risk.

For instance, globally, the spread between investment-grade corporate bonds and US Treasuries widened to approximately 170 basis points (bps) during periods of economic uncertainty in 2023. Similarly, in South Africa, the spread between corporate bonds and the 10-year government bond (currently yielding about 10.5%) has varied significantly, often reflecting heightened concerns about local political risks and structural economic challenges. In 2024, this spread hovered around 250-300 bps for local high-yield corporate bonds, indicative of the perceived elevated risk in certain sectors.

At Prescient, we take a holistic view when assessing risk premia, focusing on striking the right balance between yield and risk. With South African rates currently elevated and potential rate cuts on the horizon, it's crucial to factor this into our thinking. While chasing yield can be tempting, especially in our current interest rate environment, doing so without a rigorous understanding of the associated risks can lead to suboptimal outcomes.

This is where a systematic investment approach provides an edge. We model expected returns across different credit classes and sectors, enabling us to capture attractive risk-adjusted returns for our clients while being mindful of the evolving rate landscape and avoiding undue risks.

In South Africa, the need for tailored risk premia models is particularly acute due to the country's unique economic conditions. Sovereign credit ratings, for instance, have been under pressure due to fiscal constraints, leading to South Africa's long-term foreign currency debt rating being downgraded to sub-investment grade by Moody's, Fitch, and S&P. This, combined with currency fluctuations (the rand depreciated by over 10% against the dollar in 2023) and market liquidity issues, underscores the need for dynamic models that can adjust risk premia expectations in real-time.

Globally, we observe similar trends, where geopolitical risks, inflationary pressures, and central bank policies are key determinants of risk premia. In 2023, as the US Federal Reserve raised rates to combat inflation, credit spreads widened, reflecting increased compensation for risks in a rising interest rate environment. Emerging markets, including South Africa, faced currency depreciation, and tightening liquidity, further influencing local credit risk premiums.

In South Africa, where the economy is marked by volatility and structural challenges, we've developed models tailored to local conditions. These models help us dynamically adjust our credit risk and risk premia expectations based on various macroeconomic factors, including but not limited to our views on our sovereign and market volatility, currency fluctuations, and liquidity. This rigorous analysis is vital for maintaining portfolio resilience in an environment where macroeconomic shifts can be swift and severe.

> While noting the above, balancing credit quality with risk premia is essential. This requires not only the approach detailed above but also a patient, disciplined approach. We don't chase the highest yields at the expense of quality. Instead, we leverage our systematic framework to build portfolios that can perform across economic cycles.

For example, high-yield debt offers significant risk premia but requires deep credit research and careful selection. We focus on issuers where the risk premia are justified by the underlying business drivers – companies that may be undervalued due to temporary issues but have solid long-term prospects. Our models help us identify these opportunities while avoiding pitfalls in sectors or issuers that carry disproportionate risk.

Importantly, as we continue adjusting to a post-pandemic reality, inflation concerns, volatile interest rates, and geopolitical tensions continue to shape the fixed-income landscape. For South African investors, this means navigating local challenges while staying attuned to global trends. Prescient Investment Management's investment strategies are built to withstand these headwinds. We systematically assess both credit quality and risk premia, ensuring our clients are rewarded for the risks undertaken without sacrificing long-term security.

Our view remains steadfast, with the focus on credit quality and risk premia being more critical now than ever. A robust, data-driven approach enables us to navigate complex market environments while delivering consistent, risk-adjusted returns to our clients.

> As one of South Africa's leading systematic asset managers, Prescient remains committed to rigorous investment analysis, prudent risk-taking, and fulfilling our fiduciary duty to protect and grow client assets in these uncertain times.

Why patience, diligence, and diversification matter in systematic investing

by CONWAY WILLIAMS
Head of Credit

and SAJJAAD AHMED*
Portfolio Manager

By adhering to a disciplined, evidence-based framework, one is able to maintain stability and resilience, positioning portfolios to achieve sustained success.

**Representative acting under supervision.*

In investing, striving for and achieving optimal balance is crucial for long-term success. We understand that this success hinges on meticulously calibrating strategies to be neither too aggressive nor overly cautious – striking this balance is essential, so as not to expose investors to unnecessary risks; or result in missed opportunities for growth. Being alert to where one is in the market cycle and having the ability to adjust strategies accordingly is key to navigating market complexities and delivering on client promises.

Research shows that this "balance" can be achieved through:

- patience
- diligence in analysis, and
- diversification

This trifecta can guide investors to long-term success.

Patience

Patience is a cornerstone of successful investing. Particularly evident during volatile markets, where prices fluctuate based on numerous factors, impulsive decisions can lead to significant setbacks. Warren Buffett's adage, "The stock market is designed to transfer money from the Active to the Patient," fully encapsulates the value of patience.

It is a well-documented fact that investors who practice patience are better equipped to withstand short-term market fluctuations and also capitalise on long-term growth opportunities. Research and financial literature abound on this topic, from key contributors such as Jeremy Siegel (Wharton School of Business) to the seminal work by Fama and French almost 30 years ago, talking to the notion that short-term investments can be highly volatile, yet long-term investments in diversified portfolios generally yield higher returns.

Diligence in analysis

Successful investing hinges on thorough analysis, rigorous testing, and careful consideration of risk. A well-functioning process requires robust research, and diligence in analysis. This involves conducting deep research into macroeconomic variables, thorough evaluation of financial data, understanding market trends, and importantly, assessing the competitive landscape. Informed decisions should be based on comprehensive analysis rather than fleeting trends or speculative tips. This is not a novel idea by any stretch of the imagination, with numerous contributors detailing the impact of deep research and careful consideration of market dynamics, and reinforcing the importance of a well-functioning, research-driven investment process. With this being said, when placed at the heart of an investment process, the practice of diligent analysis ensures that investment choices are aligned with long-term objectives, and importantly, remains resilient against market pressures.

Diversification

Diversification, often referred to as the only free lunch in investing, is the practice of spreading investments across various asset classes, sectors, and geographic regions to minimise risk. This approach is essential for constructing robust portfolios capable of enduring challenging economic conditions and volatile markets. While losses are an inevitable part of investing, appropriate diversification—neither over-diversifying nor under- diversifying—enables portfolios to absorb losses more effectively while remaining invested.

By carefully diversifying, investors can protect against significant losses in any single investment, ensuring greater stability and the potential for enhanced overall returns. Adjusting allocations to reflect changing market dynamics further supports resilience and adaptability, reinforcing the strength of a well-balanced portfolio. Harry Markowitz's pioneering work on modern portfolio theory highlights how diversification helps optimise risk and return, establishing it as a core strategy in effective portfolio management.

Applying the 'rule of three':

A systematic investment process should be deeply rooted in rationality, driven by rules and evidence, with a strong emphasis on data-driven analysis to minimise human biases and enhance decision-making. Combining patience, diligence, and diversification are thus key components of this robust systematic strategy. This approach allows one to navigate complex market dynamics effectively, ensuring consistency in long-term outperformance for clients.

By adhering to a disciplined, evidence-based framework, one is able to maintain stability and resilience, positioning portfolios to achieve sustained success. This approach, applied practically, entails:

- **Patience:** Committing to a long-term investment horizon and avoiding reactionary decisions based on short-term market fluctuations.
- **Diligence:** Conducting thorough research before making investment decisions and continuously monitoring portfolios to align with evolving financial goals and market conditions.
- **Diversification:** Constructing a well-balanced portfolio that spans various asset classes and sectors, periodically rebalancing to maintain optimal risk exposure.

Importantly, this "balanced approach" underscores patience, diligence, and diversification as pillars of sustainable investment strategies. By waiting for opportune moments, rigorously analysing opportunities, and strategically diversifying portfolios, investors can navigate market complexities effectively.

> This strategy helps achieve optimal outcomes and fulfil client promises. Patience prevents hasty decisions driven by market fluctuations, allowing for capitalisation on truly advantageous opportunities. Diligent analysis provides a thorough understanding of potential investments and their associated risks. Diversification spreads risk across various asset classes, sectors, and regions, protecting portfolios from significant losses in any single area.

Following these principles fosters resilience and stability in investment strategies. This balanced approach ensures that portfolios are adaptable to changing market dynamics and positioned for sustainable growth. Consequently, investors can confidently meet long-term objectives, providing assurance that investments are managed with the utmost care and expertise.

Reference rate reform – ZARONIA and its implications.

by HENK KOTZE
Head of Cash & Income

ZARONIA addresses many of the shortfalls of JIBAR. It will result in more efficient financial transactions and ultimately boost market stability and investor confidence.

Reference Rate Reform – ZARONIA and its implications

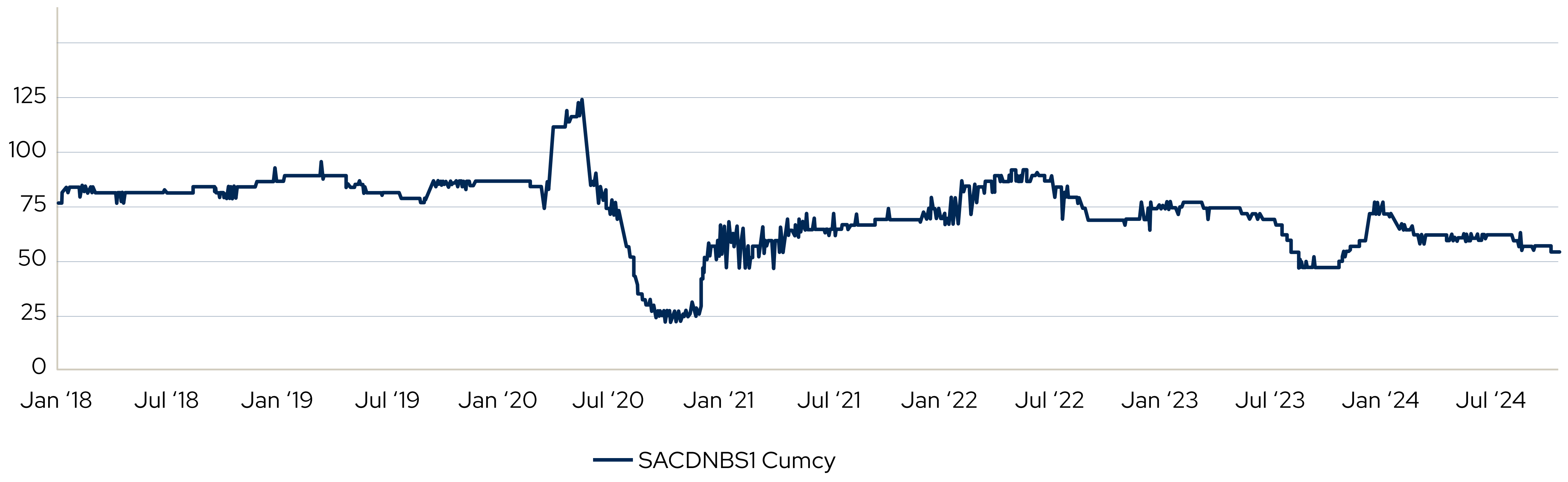
ZAR what? No, this is not an article on why the South African Rand (ZAR) has experienced a recent period of stronger performance, nor where we see it going in the future. No, this article is about something a lot more exciting (depending on who you ask). It is about reference/benchmark rate reform and more specifically the imminent change from the Johannesburg Interbank Average Rate (JIBAR) to the South African Rand Overnight Index Average (ZARONIA) and why this change is something we all should be aware of.

What is a reference rate or benchmark rate?

The inner workings of the capital markets globally as well as in South Africa is inseperably linked to the concept of a reference rate such as the current widely used 3-month JIBAR rate locally. This rate forms the basis of how market participants can price for rate expectations and use these forward expecations to efficiently manage their interest rate exposure. It also serves as the reference rate by which debt is raised by banks and other institutions needing to raise funding in the capital markets. It forms the base of the Forward Rate agreements (FRAs), the Swap curve as well as term funding curves. These are just some of the ways a reference rate is key in capital market workings. The benchmark component then comes in where this rate is used in the computing of a benchmark for fund managers, treasuries and othe rmoney managers. One such benchmark rate as an example is the STeFI rates.

As an example, the below chart shows the spread (compensation) earned on top of 3-month JIBAR if capital market participants would lend money to the top 5 banks in South Africa for a period of 12-months.

SA FRN Spreads Over 3M-Jibar: Bank Funding Spreads



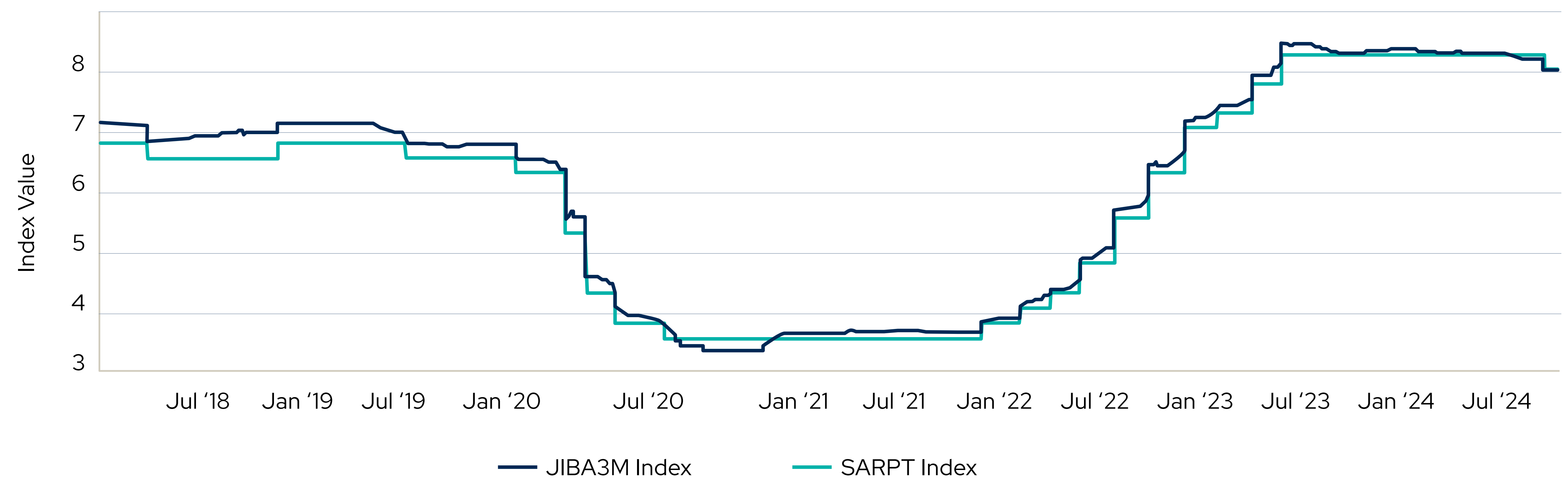
Source – Prescient Investment Management, Bloomberg as on 2024-10-21

So why the need for reform of the benchmark/ reference rate in South Africa?

Globally, financial authorities have moved to reform/ change the reference rates of countries as they were seen as not truly reflecting the traded, risk free (or near risk free) rates of the specific countries. The key example of an already reformed reference rate is the move from London Interbank Offered Rate (LIBOR) to the Secured Overnight Financing Rate (SOFR). You would do well to remember the LIBOR scandal of the early 2010s where major global financial institution (Barclays, JP Morgan and Citi Bank to name a few) were implicated in the manipulation of LIBOR. Fines, Lawsuits and major distrust in the financial industry followed and led to the fast tracking of reforming how reference rates or benchmark rates are calculated and derived.

In South Africa, with only a few banks contributing to how JIBAR is set daily, the reliability and integrity of this rate is certainly in question. The use there of is also not strictly speaking the best representation of a risk free or near risk free rate when one considers a benchmark or reference rate. JIBAR is most often quoted as a 3-month rate.

Jibar And Repo Rates



Source - Prescient Investment Management, Bloomberg as on 2024-10-21

This has further implications in that it is a bank rate purely, thus introducing (albeit small) a credit risk component and being 3-months introduces a small term risk component as well. Not a pure traded risk-free rate that a reference rate should be and does not reflect the cost at which banks fund themselves.

Given, as briefly explained above, the importance of a reference rate and how widely it impacts the workings of the Fixed Income markets but also the capital markets in general, ensuring the rate is determined in a reliable, transparent and effective manner is of utmost importance.

How imminent is the change and what are some of the benefits of the new rate?

ZARONIA addresses many of the shortfalls of JIBAR – some key benefits are 1.) ZARONIA is calculated backwards based on actual traded rates 2.) It is fairer and less complex in how it is calculated 3.) It will result in more efficient financial transactions and ultimately boost market stability and investor confidence.

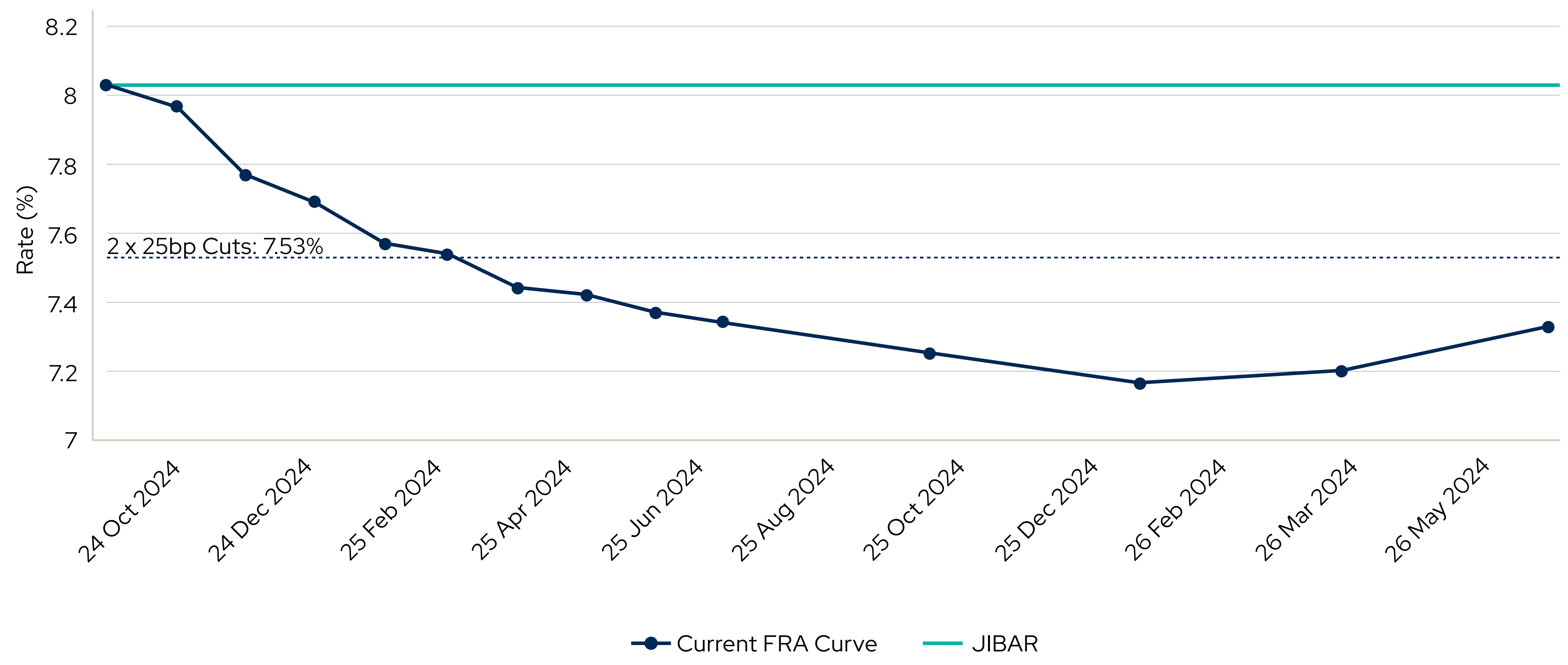
The key date to watch out for and be aware of is June 2025 when ZARONIA is set to be used in the cash/funding market as the new reference rate. This will then see the market evolve into using this as a reference rate and develop the curves as needed. It is envisaged that JIBAR will be phased out by end 2026.

How will this impact the South African Fixed Income market?

There are many implications and nuances to consider in understanding the impact. The long-term benefits have been spelled out above, but getting there will take some navigating. Things such as how to deal with long-term contracts, be it funding in nature or derivative in nature that currently references JIBAR will need to transition. Here the adjustment needs to be fair, and it is expected to involve something called a Credit Adjustment Spread (CAS) to ensure that parties are left in the same position post transition as they were pre. How systems will deal with a rate that is backward looking and not known at the start of a contract as an example will be key to understand and deal with and then mandates referencing STeFI or JIBAR might have to be repapered. These are some of the implications of this transition and why it is important to stay up to date with this development.

The below chart shows the current market pricing for the Forward Rate Agreements (FRAs) that indicates where the market expects JIBAR to be in the future. This will change as the market moves away from JIBAR to ZARONIA.

Market Pricing: Key Rates vs Forward Rate Agreements



Source – Prescient Investment Management, Bloomberg as on 2024-10-21

Conclusion

Fixed Income is generally not a very exciting topic in financial markets, let alone talking about something as specific as a change to a reference rate. It is however something that will impact almost everyone involved in financial markets in some way shape or form. Be it in how you raise funding, what benchmarks are used in mandates or as simple as following a new proxy for cash rates in the South African markets. This change is happening, it is imminent and ensuring you, your funds and mandates are ready is of utmost importance. We at Prescient Investment Management is at the forefront of this development in our capacity as custodians of our client's money and as representatives on the many industry bodies dealing with this complex process, you can rest assured we are on top of it and will keep you posted. Until next time, JIBAR and out.

Demystifying data science: how algorithms are shaping your investment portfolio

by ADAM DE WAAL
Quantitative Analyst

Data science empowers us to make more informed decisions by identifying imperceptible patterns and trends through conventional analysis.

In an era when data is often touted as the new oil, the fusion of finance and technology is transforming the investment landscape at an unprecedented pace. For retail investors, understanding how data science influences investment strategies is no longer a luxury – it's a necessity. At Prescient Investment Management (PIM), we're leveraging the power of data science to enhance portfolio performance and provide you with a competitive edge in the market.

Financial markets are a relentless torrent of information. Every tick of a stock price, every shift in economic indicators, and every newspaper headline contributes to an ever-expanding universe of data. Traditional investment approaches, reliant on fundamental analysis and human intuition, struggle to keep pace with this deluge of information. Enter data science—a discipline that harnesses advanced analytics, machine learning, and artificial intelligence to extract actionable insights from vast and complex datasets.

But what does this mean for you, the investor? At its core, data science empowers us to make more informed decisions by identifying imperceptible patterns and trends through conventional analysis. It's not about replacing the seasoned judgement of investment professionals but augmenting it with computational horsepower and algorithmic precision.

We embrace generative artificial intelligence—not to think for us but to assist us with our daily tasks and enhance productivity. Generative AI helps automate routine processes, analyse extensive datasets more efficiently, and generate preliminary insights supporting investment decisions. By streamlining these tasks, our teams can focus on strategic analysis and personalised client service, ensuring you benefit from both technological innovation and human expertise.

Machine learning algorithms, capable of learning and adapting without explicit programming, are at the heart of our predictive analytics. These models analyse historical data to identify patterns and then apply this knowledge to forecast future market movements. While no model can predict the future with absolute certainty, machine learning enhances our ability to anticipate market trends and position your portfolio accordingly.

It's also important to emphasise that data science doesn't diminish the value of human expertise—it enhances it. Our team of investment professionals collaborates closely with data scientists, combining quantitative models with qualitative insights. Human judgement remains crucial in interpreting data, understanding context, and making decisions that algorithms alone cannot.

The practical benefits of this approach are tangible. By integrating data science into our investment processes, we can react swiftly to market developments, optimise asset allocation, and uncover opportunities that might otherwise be overlooked. For you, this means a more resilient portfolio designed to navigate volatility and capitalise on growth opportunities.

As technology continues to evolve, the role of data science in investment management will only become more significant. Artificial intelligence and machine learning models will grow more sophisticated, processing ever-greater volumes of data with increasing accuracy. Staying ahead in this environment requires a commitment to innovation and continuous improvement, which PIM wholeheartedly embraces.

In conclusion, data science is reshaping the investment landscape, offering powerful tools to enhance decision-making and performance. By demystifying these technologies, we aim to give you confidence and clarity in how your investments are being managed. After all, in a world awash with data, it's not the abundance of information that counts but the ability to transform it into meaningful insights.

Investing is, and always will be, about making informed decisions in the face of uncertainty. By harnessing the power of data science, we're not just keeping pace with the future – we believe our methodology is the future of investing.

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 Flexible Bonds Fund

Savings for retirement, offering systematic exposure to local bonds, enhanced with high-performing yield assets

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

Prescient

INVESTMENT MANAGEMENT

Cape Town

Block B, Silverwood, Silverwood Lane
Steenberg Office Park, Tokai, 7945
Tel: +27 21 700 3600
Fax: +27 21 700 3700

Johannesburg

Unit 7, First Floor, Katherine & West
114 West Street, Sandton, 2196
Tel: +27 11 044 2600
Fax: +27 11 044 2601