

# PRESCIENT

## WHEN THE “FREE LUNCH” IS NOT ALWAYS FREE... AT LEAST IN THE SHORT TERM.

In investment terms, we’re all too familiar with the relationship between returns and risk. Investors can’t earn returns above the risk-free rate if they’re not willing to take on some risk. Risk just means investing in an asset that can result in capital losses, and to expose yourself to that, you should be rewarded by returns exceeding the risk-free rate.

In investments, we’re also familiar with the saying that diversification is the only free lunch. By spreading your investments in unconcentrated pots across a range of asset classes and geographies, the principle is that they don’t all perform in sync, so when one or more of these pots take a knock, others do well and compensate. The end game is a portfolio that exhibits more stability in returns for the level of overall risk taken. We refer to that as increased efficiency.

This time, things were different and unprecedented. From mid-February to mid-May, the sell-off in markets due to COVID-19-induced paranoia made us realise that there might be another “free lunch” – namely “time”.

The table below compares the long-term correlation of various pots on the bottom left to the correlations observed during the recent market sell-off in the top right. During the sell-off, especially for South African investors, there was virtually no place to hide. The red colouring in the top right side of the table indicates

	SA Equities	SA Property	SA Bonds	SA ILBs	SA Alternatives	SA Income	SA HY Corp	SA Prefs	SA Cash	DM Equities	DM Small Caps	DM Property	EM Equities	EM Small Caps	DM Bonds	DM IG Corp	DM HY Corp	EM \$ Bonds	DM Income	DM Cash	Currency Hedge
SA Equities		0.77	0.73	0.37	0.11	0.25	0.57	0.49	-0.37	0.76	0.82	0.88	0.95	0.93	-0.16	0.42	0.83	0.81	0.57	-0.26	0.65
SA Property	0.44		0.82	0.56	0.21	0.60	0.81	0.73	-0.38	0.44	0.57	0.75	0.79	0.83	0.17	0.55	0.78	0.83	0.72	-0.07	0.49
SA Bonds	0.21	0.41		0.63	0.09	0.58	0.86	0.60	-0.33	0.56	0.63	0.80	0.74	0.78	-0.16	0.46	0.85	0.76	0.82	-0.11	0.60
SA ILBs	0.05	0.20	0.22		0.15	0.79	0.69	0.57	-0.14	0.36	0.51	0.62	0.42	0.47	0.28	0.72	0.66	0.61	0.56	-0.11	0.45
SA Alternatives	-0.05	-0.01	-0.06	0.08		0.19	0.21	0.20	0.02	-0.15	-0.04	0.04	0.07	0.13	0.16	0.22	0.13	0.16	0.20	0.28	-0.05
SA Income	-0.08	0.09	-0.08	0.09	-0.03		0.68	0.68	-0.20	0.05	0.19	0.37	0.30	0.41	0.38	0.66	0.51	0.55	0.65	0.07	0.22
SA HY Corp	-0.11	-0.01	-0.07	0.04	0.18	0.21		0.61	-0.08	0.39	0.50	0.67	0.58	0.66	0.17	0.57	0.73	0.73	0.78	-0.03	0.44
SA Prefs	0.15	0.32	0.16	0.14	0.01	0.21	0.04		-0.21	0.20	0.25	0.49	0.58	0.69	0.14	0.55	0.69	0.70	0.80	0.04	0.49
SA Cash	-0.04	-0.01	-0.05	0.17	0.32	0.22	0.26	0.07		-0.24	-0.27	-0.29	-0.41	-0.37	0.19	-0.05	-0.31	-0.24	-0.22	-0.10	-0.12
DM Equities	0.65	0.30	0.25	0.05	-0.08	-0.25	-0.15	0.10	-0.07		0.96	0.87	0.76	0.66	-0.36	0.28	0.75	0.59	0.27	-0.27	0.78
DM Small Caps	0.62	0.31	0.24	0.05	-0.08	-0.23	-0.15	0.11	-0.12	0.95		0.93	0.81	0.73	-0.16	0.45	0.80	0.71	0.32	-0.32	0.76
DM Property	0.57	0.37	0.29	0.06	-0.12	-0.20	-0.17	0.14	-0.16	0.83	0.85		0.89	0.86	-0.12	0.56	0.92	0.85	0.60	-0.21	0.79
EM Equities	0.73	0.41	0.32	0.07	-0.14	-0.18	-0.17	0.14	-0.06	0.74	0.72	0.73		0.97	-0.18	0.45	0.90	0.86	0.62	-0.27	0.72
EM Small Caps	0.63	0.42	0.31	0.06	-0.17	-0.13	-0.16	0.18	-0.14	0.64	0.65	0.69	0.92		-0.11	0.52	0.91	0.90	0.73	-0.23	0.70
DM Bonds	-0.24	-0.02	0.01	0.04	0.10	0.17	0.11	0.02	0.20	-0.37	-0.34	-0.21	-0.26	-0.22		0.61	-0.13	0.20	0.00	0.13	-0.24
DM IG Corp	0.00	0.18	0.18	0.11	0.03	0.11	0.07	0.16	0.06	-0.04	-0.02	0.10	0.03	0.08	0.65		0.61	0.78	0.56	-0.07	0.42
DM HY Corp	0.33	0.33	0.20	0.10	-0.07	-0.02	0.01	0.21	-0.09	0.38	0.41	0.42	0.39	0.45	-0.12	0.24		0.92	0.76	-0.20	0.80
EM \$ Bonds	0.43	0.40	0.40	0.15	-0.09	-0.09	-0.07	0.23	0.03	0.53	0.50	0.55	0.58	0.56	0.10	0.40	0.42		0.75	-0.19	0.69
DM Income	-0.02	0.00	-0.02	0.01	0.01	0.00	-0.01	0.01	-0.02	-0.01	-0.01	0.00	-0.02	-0.02	0.02	0.00	0.00	0.00		0.09	0.50
DM Cash	-0.09	-0.02	-0.05	0.15	0.27	0.18	0.20	0.06	0.67	-0.10	-0.14	-0.16	-0.09	-0.14	0.21	0.02	-0.11	0.01	-0.03		-0.18
Currency Hedge	0.22	0.18	0.39	0.06	-0.04	-0.39	-0.14	0.04	-0.02	0.53	0.51	0.45	0.44	0.35	-0.11	0.05	0.14	0.39	0.01	-0.04	

Covid-19 Crisis - 01 Feb 2020 - 31 March 2020

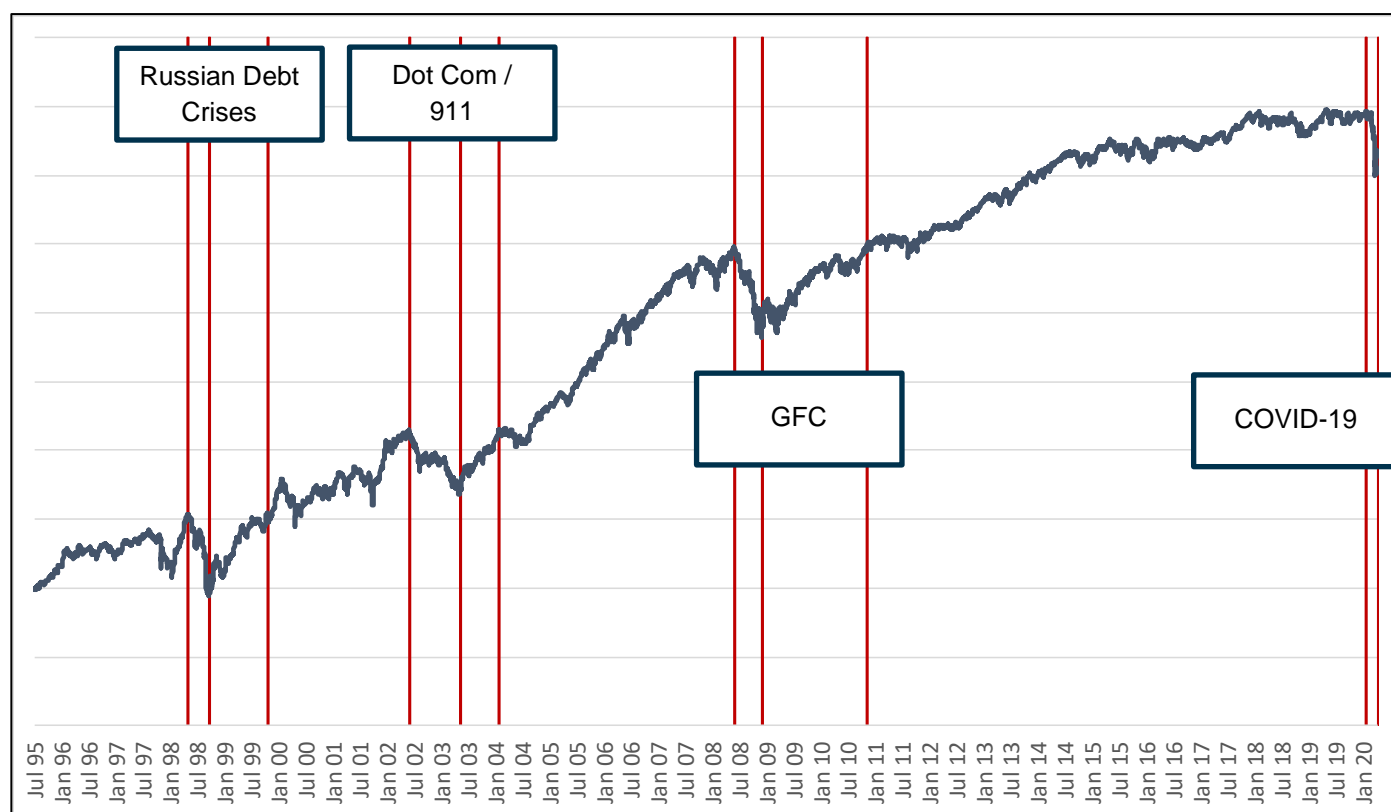
Long-Term Correlations - 31 Dec 2003 - 31 March 2020

that correlations increased, mitigating the free lunch of diversification for a little while. The average correlation between pots moved from 0.14 to 0.40 – a level much higher than what we observed during the Great Financial Crisis.

**Sources: Bloomberg, Prescient**

Therefore, after experiencing so much pain recently, what should we do? Stay calm and enjoy this second free lunch – time. We are convinced that in time, correlations will normalise and diversification benefits will return.

The graph below shows the progression of the JSE All Share Index since 1995. The current COVID-19 crisis is the fourth major bear market SA equity investors have experienced since our economy opened up.



**Source: Bloomberg**

Notable from the graph as shown in the table below: markets crash, markets recover, markets grow and then markets crash again.

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Event	Bear % Fall	Months to Recover	Months to Next High	Return p.a. to Next High
Russian Debt	-42.3%	13	31	23.8%
Dot Com/911	34.6%	9	61	38.5%
GFC	-45.3%	23	134	8.4%
COVID-19	-23.9% *			

\* to 31<sup>st</sup> March 2020.

We recognise that in a world where human behaviour overlays real-time information dissemination automatic trading systems, volatility can at times be severe, even lethal. We don't know what the future holds, but we do know that it pays to be patient and not get emotional. And that the next growth phase will come.

ENDS

About Prescient:

- Prescient Holdings (Pty) Ltd is a diversified, global financial services group with a 21-year track record of providing solutions to our clients in Asset Management, Investment and Platform Administration, Retirement Solutions, Stockbroking and Wealth Management. As at 31 Dec 2019 the group had R98.4 billion client assets under management (AUM) and administered R478 billion client assets (AUA), split between asset admin (R328 billion) and unit holder admin (R150 billion). Prescient has established operating businesses in the following main jurisdictions: Prescient has successfully operated for 21 years in South Africa, 12 years in Ireland & the UK and 6 years in China.
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