Q2 | June 2020

STAND POINT

STANLIB

FINDING OPPORTUNITY AMIDST MARKET CHALLENGES

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FROM OUR STANDPOINT

A note from our head of Institutional Distribution,

TRACY COETZER

In our first edition of STANDPOINT in 2020, we were subdued about our local economic prospects and cautiously optimistic about the outlook for global growth. What we didn't foresee, was that within a few short weeks the words 'lockdown' and 'social distancing' would become part of our daily vocabulary. Some weeks later, we are still coming to terms with the magnitude of the coronavirus pandemic on our daily lives, the markets and global economies.

Initially, the dramatic sell-off saw asset prices falling faster than they have in many decades. We then witnessed some order returning to markets as extraordinary government support helped to reduce the extreme volatility experienced in March.

Despite these and other efforts to contain the impact of COVID-19, there is lingering uncertainty about how long the effects of the pandemic will last and exactly how our economy and the world will emerge in a post-COVID-19 environment.

While the situation continues to unfold and questions about the future remain unanswered, it is important for investors to stay committed to their investment strategies. We need to remember that change is inevitable and a market recovery will follow this crisis. Staying invested means that we can participate in subsequent market gains to recover 'paper' losses experienced during this time.

Our portfolio managers are critically monitoring the markets and will remain true to their investment philosophies and not react to short-term noise, but consider the longer-term impact of events.

In this edition

In this edition of STANDPOINT, we look ahead to how we move through the upheaval caused by COVID-19 and at what could emerge.
Our Chief Economist, Kevin Lings, provides some interesting themes that may play out and bring attractive growth opportunities as a result of fundamental socio-economic shifts.
Many of these themes are echoed by our Head of Investments, Mark Lovett, and form a framework for our investment teams when thinking about risks and opportunities that lie ahead.

Joao Frasco, Head of Investments at STANLIB Multi-Manager, shares an interesting analysis of market returns leading up to and following market drawdowns.

Ann Sebastian, a Portfolio Manager in STANLIB Index Investments, reminds us that recoveries are inevitable, and she provides a thought-provoking analysis of which equity styles could perform in various market-recovery scenarios.

Looking globally, we consider property markets and Nicolas Lyle, a Senior Analyst focusing on REITs and listed property funds, paints an interesting perspective of growth trends and how investing in specific property sectors could provide return opportunities going forward.

As we stand together to fight this global pandemic and drive a path to both health and economic recovery, we thank you for trusting STANLIB to navigate these markets in extraordinary times. We hope our series of webinars over the last month have kept you well informed and close to our investment teams' thinking.

We also hope this edition of STANDPOINT provides you with key insights and a balanced perspective about our expectations for a future beyond the pandemic.

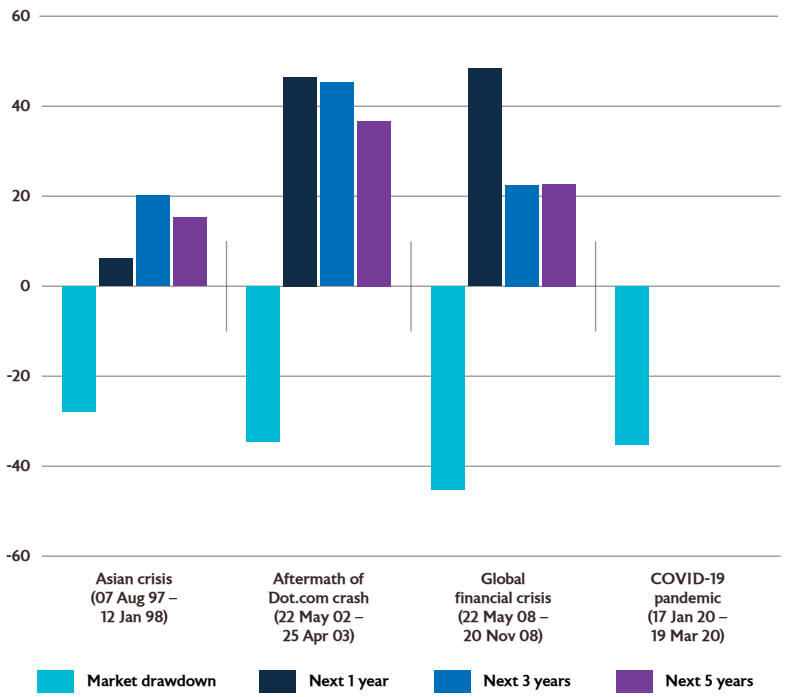
We welcome your feedback and comments; please stay in touch and stay safe.

Regards,
Tracy

CHARTICLE:

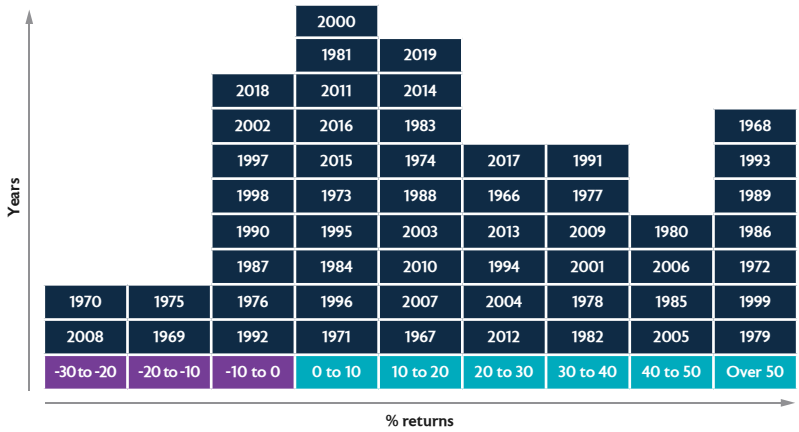
MORE UPS THAN DOWNS

Market drawdowns and subsequent returns



Source: Morningstar, South African All Share Index (ALSI)

Markets have gone up more than down



Source: Morningstar, IRESS

Sudden and significant market sell-offs, such as the one recently experienced, may initially be alarming and disconcerting to any investor. However, it is important to remember:

1. **Recoveries follow sell-offs:**
   Market sell-offs have always been followed by a market recovery.

2. **Buy low and sell high:**
   Market declines are often the forgotten part of the investment cycle. While unnerving in the short term, these times provide an attractive entry point for long-term investors.

3. **Don't miss an opportunity:**
   The sharp recovery from the bottom in March (whether it is sustained or not) clearly shows the risk of crystallising losses if moving too quickly out of the market during periods of uncertainty – as tempting as this may be.

4. **Beating inflation over the long term:**
   Growth assets, such as equities, tend to outperform more defensive assets over the long term, and provide a good hedge against the corrosive effect of inflation.

WHAT MIGHT THE WORLD LOOK LIKE AFTER COVID-19?

By Chief Economist
KEVIN LINGS

The COVID-19 outbreak has wreaked havoc on global health systems, with the subsequent lockdown measures completely disrupting personal and work lives across the world. People are wondering whether this represents a turning point in the way society functions.

Historical events suggest that some of the changes we are experiencing are unlikely to be permanent: the longer-term consequences of both 9/11 in the US and the Global Financial Crisis (GFC), for example, were relatively modest and concentrated in particular sectors, such as airline travel and the financial services industry. This was despite many people predicting at the time that these events would radically change social behaviour going forward. This supports the argument that once COVID-19 is mostly under control (perhaps sometime during 2021), a large part of our daily lives will, undoubtedly, return to normal.

However, in the past, global pandemics have had longer-lasting effects on society. This was certainly evident after the Spanish Flu in 1918/19, which significantly affected the healthcare system, and partially contributed to the baby boom in the 1920s.

Much like the Spanish Flu, COVID-19 has affected almost every person in the world, and we need to anticipate some important residual changes that will

transform the way societies operate and people behave. These potential changes can be grouped into three broad categories: behavioural, economic and social interaction.

Behavioural changes

Practicing good hygiene

The rapid spread of COVID-19 has increased our general awareness of hygiene and the importance of developing good hygiene habits. Along with increased hand-washing practices, the use of face masks will become more common, especially during 'flu season'. COVID-19 has shown us how easily germs can spread and just how vulnerable we are to getting sick if we don't maintain good hygiene. In addition, both households and government institutions have become more conscious of what is required to contain the spread of disease, and presumably health authorities will be better prepared should another pandemic emerge. A good example is the way in which South Korea has managed the spread of COVID-19, drawing from the lessons of the country's mistakes in handling the spread of the MERS virus in 2015.

Increased focus on service delivery

The pandemic is also exposing the deficiencies in government service delivery systems, forcing governments around the world to learn how to deliver public goods more effectively. After the experience of COVID-19, governments will be better prepared to provide social backstops and benefits to more citizens. However, to ensure this, they must use this opportunity to create systems that serve citizens more effectively. In South Africa, for example, the government should come out of this crisis better able – in theory at least – to expand its capabilities through improved food parcel delivery systems, better access to healthcare and increased water supply provisions.

Changes to economic systems and policies

(Un)importance of China

The COVID-19 outbreak has exposed a number of weaknesses in the global economic system. For one, it has highlighted the world's reliance on China for the provision of many manufactured goods. This has resulted in major disruptions in the provision of many goods that are key to both the household sector and businesses for the maintenance and repair of equipment. This is likely to encourage companies to reduce their reliance on China by upscaling and improving their local production capabilities. This will allow them to localise supply chains or find alternative sources of supply that can be used to diversify the risk of becoming over-reliant on one supplier.

In addition, the general displeasure expressed by many Western nations with China's handling of the coronavirus outbreak is likely to lead to even greater nationalism and some reversal in globalisation. This implies increased protection for local industry, and, therefore, a post-COVID-19 world may be one that is only a global village online. Even global tourism will take a while to restart, as people remain cautious about international travel.

Saving for a 'rainy day'

The lockdown measures introduced by most countries have also highlighted the lack of precautionary savings by households and, more importantly, by companies. Consumption habits have left them unprepared for the effects of a worldwide lockdown on incomes and revenue. The income uncertainty produced by the outbreak should result in businesses and individuals recognising the importance of 'rainy day' savings. Research shows that in times of increased uncertainty, households tend to increase precautionary savings. Indeed, this is something that was observed in many countries during the 2008 GFC.

We may also see more stockpiling as a form of increasing precautionary savings. This may translate into more 'doomsday preppers', as people make sure that they are well prepared to face future calamities. This may not, however, be as common in many low-income and emerging economies, such as South Africa, where people mostly live from pay cheque to pay cheque. In addition, South African households generally have a poor savings culture, meaning that they may remain vulnerable to potential loss of income in the future.

Of equal concern is the fact that many South African businesses do not have adequate safety nets for situations where there is a sudden halt in economic activity and cash flow. This lack of precautionary savings places a great deal of pressure on government to provide households and firms (especially small- and medium-sized businesses) with safety nets to prevent wide-scale job losses. As such, it may be prudent for government to introduce regulations that require businesses (of a certain size) to hold a prescribed amount of their earnings in the form of precautionary savings, much like the Basel requirements imposed on banks following the GFC. Liquidity and capital requirements on companies may help avoid large-scale job losses and prevent these companies from depending on government during times of distress.

Taxes may go up

From a policy perspective, once this pandemic is over, countries will face very significant fiscal pressures, necessitating changes in tax systems. In South Africa, for example, the long-term fiscal consequences of COVID-19 will be enormous. The government may have little choice but to look at adjusting both the corporate

and income tax regimes in order to help address the large fiscal deficits.

Unconventional monetary policy goes mainstream

Furthermore, many unconventional monetary, fiscal and financial policies may become mainstream. The unprecedented monetary and fiscal response to the crisis will raise questions about whether such policies should become more permanent in nature. This may increase government and central bank policy toolkits by introducing things like modern monetary theory, debt forgiveness and a universal basic income. Many of these radical economic and financial policies have associated risks that need to be thought through carefully before they are fully implemented.

Changes to the way we work, live and play

Remote working becomes a more practical option

The outbreak is likely to accelerate corporate acceptance of remote working by employees, and may change the way we disseminate information. With many companies being forced to allow employees to work from home, software and applications once thought to be nice to have – like Zoom, Microsoft Teams and Skype – have become critical to their functioning. Not only have people become more familiar with the use of workplace digital tools, in many cases, it has proven to be more effective. For instance, the use of platforms, such as Zoom, for seminars, conferences and meetings has meant that information is delivered to more people at a fraction of the cost.

Not only will working remotely become common for many companies, but the need for people to be physically present for conferences and meetings will also decrease. This will help companies and employees save on things, such as travel expenses and accommodation, and become a more cost-effective way of working. While this will result in losses in some parts of the economy, such as accommodation and commercial property development, it will lead to higher demand for internet access and an increase in investment in R&D for software that will make working remotely easier.

Climate change slows down

The spread of COVID-19 and the subsequent lockdowns have brought about unprecedented drops in carbon emissions, amid decreased demand for electricity, a fall in road and air traffic, and the closure of many businesses. Going forward, hopefully this will help slow the course of climate change. This, however, will depend on the long-term political decisions made about carbon emissions.

Consumers go digital… and stay digital

Another area of change that will come from the virus is our increased acceptance of e-commerce and internet-based activity. The fear of infection, closure of many entertainment facilities, and strict social distancing measures have resulted in increased use of online shopping and entertainment platforms. While the use of online shopping has been on the rise over the years, lockdowns have heightened awareness, of and comfort with, the online payment and delivery processes. Online shopping and contactless delivery have been widely allowed and encouraged by governments, especially within China, the UK, Australia, the US and European countries. Thus, COVID-19 has accelerated the popularity of online shopping and increased its importance to retail activity.

Subscriptions to online entertainment and gaming platforms, such as Netflix, Showmax, PlayStation Now and Google Stadia, may replace some traditional forms of entertainment. While the use of these streaming services may decline as the lockdown is lifted, the convenience of such services means that a residual customer base will remain subscribed. Much like working from home, this will increase R&D funding for this market, increase the demand for higher quality internet access, and lead to growth in AI and virtual reality.

Slow food beats fast food

Finally, on a lighter note, the lockdown may reduce South African households' heavy reliance on fast-food takeaways and restaurants in general. Over the years, South Africans have increased the frequency of their fast-food purchases, driven by a wider offering to consumers from new entrants and the convenience introduced by mobile delivery applications. The ban on the sale of hot cooked food during the lockdown has forced many South Africans to cook and bake as a form of entertainment, with the help of the internet. Some have even tried to recreate their favourite fast-food meals, such as fried chicken, with varying success. Many people may choose to continue this post-lockdown, not only because it is healthier but also because of the uncertainty around hygiene practices in commercial kitchens. Furthermore, voluntary social distancing may continue, decreasing demand for meals at restaurants, fast-food or otherwise.

While some of these changes will be more immediate, a lot of the change that will come from the pandemic will be slower, taking years to be implemented. Despite this, however, the outbreak of COVID-19 has exposed a lot of what is wrong with our 'normal' way of living, serving as a catalyst for some much-needed changes to some key aspects of our lives. ■

THE STRUCTURE OF MARKET DRAWDOWNS

– A HISTORICAL PERSPECTIVE

By Chief Investment Officer – STANLIB Multi-Manager
JOAO FRASCO

Studying and understanding how the current market environment compares with similar periods historically are both fascinating and informative. Analysing the past informs our understanding of what markets are experiencing today and how they may behave in the future.

Anyone who has been investing long enough would have experienced an equity market drawdown. A drawdown refers to the time period between a market peak and a market trough. These periods can be fairly significant in length and magnitude during times of crisis, such as world wars, a financial crash and pandemics. Many articles have been written about how long these drawdowns have lasted and how quickly markets have recovered thereafter, illustrating why you should remain invested. This analysis looks at drawdowns from a slightly different angle, exploring the performance of the market before and during the drawdown period.

Recovering from the worst drawdowns

This analysis considers the performance of the South African equity market and starts by gaining an understanding of the drawdowns this market has experienced historically. Using monthly data (daily data would yield different results) for the South African equity market going back to 1925*, we calculate the 10 worst (largest) drawdowns. Table 1 provides the relevant summary information on each of these drawdowns.

*Relevant equity market data over the period

Table 1: 10 Worst drawdowns since 1925

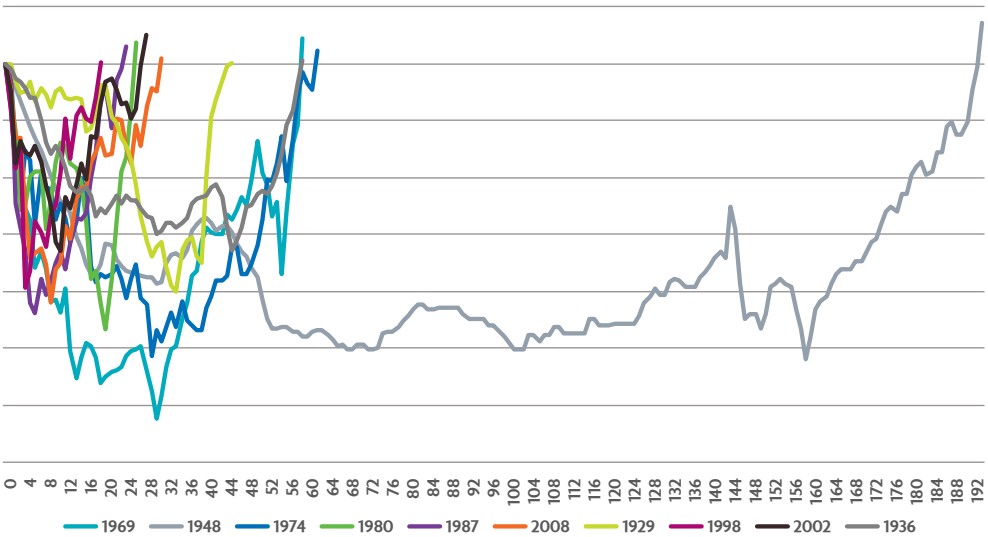
Rank	1	2	3	4	5	6	7	8	9	10
Drawdown	-61,9%	-50,4%	-49,3%	-46,4%	-43,3%	-42,0%	-40,0%	-39,4%	-32,9%	-32,8%
Period to bottom	30	159	29	20	5	9	34	4	11	45
Period to recover	29	33	30	6	18	22	11	15	17	14
Begin	1969/04	1948/01	1974/03	1980/10	1987/09	2008/05	1929/09	1998/04	2002/05	1936/10
Bottom	1971/10	1961/04	1976/08	1982/06	1988/02	2009/02	1932/07	1998/08	2003/04	1940/07
End	1974/03	1964/01	1979/02	1982/12	1989/08	2010/12	1933/06	1999/11	2004/09	1941/09
Total period	**59**	**192**	**59**	**26**	**23**	**31**	**45**	**19**	**28**	**59**

Source: C Firer's research, IRESS, STANLIB Multi-ManagerC

While the average length of the drawdown was around 35 months (almost three years), the data shows that, in four instances, it took less than one year to reach the bottom. And all except one were less than three years. The recovery, by comparison, took on average 20 months. So, if you are going to exit the market during market drawdowns, it is best to get back in relatively quickly as the recovery could be swift. Recoveries on average take less time than drawdowns.

Chart 1 shows the path of these 10 worst drawdowns, illustrating in many instances the quicker recovery period.

Chart 1: Evolution of the worst 10 drawdowns since 1925



Source: C Firer's research, IRESS, STANLIB Multi-Manager

But what happened before the drawdown?

Investments rarely start with a drawdown, so while it is important to think about the structure of drawdowns, it could be enlightening to think about investment returns earned in the equity market in the period before a drawdown. Thinking about the returns achieved before the drawdown could be as important as understanding the pattern of the recovery, because the capital value lost in the drawdown may have been earned from the same market.

So, let's turn our attention to what happened before these drawdowns. Table 2 shows the same 10 drawdowns, but now considers the time that was required to achieve the same return as the drawdown, i.e. the drawdown in reverse. On the previous page, we considered the time required to recover from the drawdown, we are now considering the time required to achieve the return that was subsequently lost during the drawdown. You will, therefore, note that a couple of the values in Table 2 correspond to Table 1.

Table 2: Returns lost as a result of drawdowns

Rank	1	2	3	4	5	6	7	8	9	10
Drawdown	-61,9%	-50,4%	-49,3%	-46,4%	-43,3%	-42,0%	-40,0%	-39,4%	-32,9%	-32,8%
Period to achieve	40	57	25	13	15	29	47	50	24	18
Period to remove	30	159	29	20	5	9	34	4	11	45
Beginning	1966/01	1943/05	1972/03	1979/10	1986/07	2006/01	1925/11	1994/03	2000/06	1935/05
Top	1969/05	1948/02	1974/04	1980/11	1987/10	2008/06	1929/10	1998/05	2002/06	1936/11
End	1971/11	1961/05	1976/09	1982/07	1988/03	2009/03	1932/08	1998/09	2003/05	1940/08
Total period	**70**	**216**	**54**	**33**	**20**	**38**	**81**	**54**	**35**	**63**

Source: C Firer's research, IRESS, STANLIB Multi-Manager

On average, it took 32 months to achieve the returns that were subsequently lost through the drawdown period. This may sound like a long time, and while it may be disappointing to return to where you were three years before, this is a relatively short period of time when you consider that investing in equity aims to provide long-term growth for a lifetime of savings. And, as shown, the impact of an equity market drawdown over the long term and especially when combined with a recovery, is not as significant as you might think.

What about returns around drawdowns?

Another way to think about equity market drawdowns, is to consider what happened with returns before and after the drawdown. This is similar to what has been done above, but fixes the period being considered instead of fixing the returns achieved to either the recovery period, or the period required to achieve the return that would be lost. Table 3 provides the annualised returns for the period before the drawdown started (the peak) and for the same period of time after this point, as well as the full period (combined).

Table 3: Annualised returns around the start of the drawdown

	Rank	1	2	3	4	5	6	7	8	9	10	Average
1 YEAR	**Prior**	60,6%	33,3%	36,8%	82,6%	41,7%	11,2%	6,7%	14,8%	20,8%	31,7%	34,0%
	Hence	**-39,9%**	**-24,2%**	**-25,9%**	**-14,0%**	**-33,9%**	**-28,5%**	**-6,2%**	**-9,7%**	**-23,5%**	**-18,5%**	**-22,4%**
	Combined	**-3,4%**	**1,1%**	**1,4%**	**57,1%**	**-6,4%**	**-20,5%**	**0,1%**	**3,7%**	**-7,6%**	**7,3%**	**4,0%**
3 YEARS	**Prior**	35,8%	21,6%	31,3%	56,9%	41,3%	32,2%	11,7%	14,4%	22,1%	22,7%	29,0%
	Hence	**-16,2%**	**-12,3%**	**-16,9%**	**-1,1%**	**0,6%**	**0,8%**	**-11,6%**	**6,4%**	**7,2%**	**-10,0%**	**-5,3%**
	Combined	**13,9%**	**6,6%**	**9,2%**	**55,2%**	**42,2%**	**33,2%**	**-1,3%**	**21,7%**	**30,9%**	**10,4%**	**22,1%**
5 YEARS	**Prior**	21,9%	17,1%	3,0%	30,7%	31,8%	30,0%	0,0%	17,9%	12,2%	20,7%	18,5%
	Hence	**-0,5%**	**-12,2%**	**0,3%**	**7,8%**	**3,5%**	**5,7%**	**7,3%**	**0,3%**	**20,6%**	**-0,2%**	**3,3%**
	Combined	**21,3%**	**2,8%**	**3,3%**	**40,9%**	**36,5%**	**37,5%**	**7,3%**	**18,2%**	**35,4%**	**20,5%**	**22,4%**

Source: C Firer's research, IRESS, STANLIB Multi-Manager

If you focus only on the average column, you will note that the averages over the combined periods are positive. Recall that these are the 10 worst drawdown periods since 1925. Again, as painful as drawdowns are, especially when you are living through one and have to draw an income from your fixed pool of capital, the returns over even reasonably short periods of time are, on average, better than one might expect, especially as we increase the time period.

> *Staying invested in equity markets through the drawdown and beyond, provides an opportunity to participate in the recovery and ensure you achieve a positive, real return over the longer term.*

How do we relate this to the current market drawdown?

Let us end by putting the current drawdown into context. The current drawdown began in December 2017 when our equity market reached a significant high. The drawdown period has continued for the last 28 months, and at 31 March 2020, we were at the lowest point thus far.

However, it is impossible to know whether the market will move lower. While it has recovered substantially in April, this could change given the continued market uncertainty driven by the pandemic. Measuring -25.6% over the period would make it the 11th-worst drawdown thus far, and at 28 months, it is the 6th longest to reach the bottom, if this is indeed the bottom.

We can't be sure how long it will take to recover, but what the analysis shows is that over time, the impact of a drawdown, especially when combined with the recovery period which is typically shorter, is limited. Staying invested in equity markets through the drawdown and beyond, provides an opportunity to participate in the recovery and ensure you achieve a positive, real return over the longer term. ■

TILTING TOWARDS OPPORTUNITIES DURING A MARKET CRISIS

By Portfolio Manager – STANLIB Index Investments
ANN SEBASTIAN

Since the outbreak of COVID-19, and the accompanying turbulence on global markets, there has been no shortage of financial market opinions and rhetoric. The beginning of March 2020 ushered in a widespread sell-off across asset classes and geographies as investors switched to safer strategies or disinvested altogether.

The fundamental principles of investing dictate that in uncertain times only steady and rational minds can position investors to benefit from market shocks, and prepare them for the inevitable recoveries.

Rational investors should focus on trends and opportunities based on prevailing investment style factors. These style factors include well-known ones, such as value, growth, quality and momentum. Investors must understand how their equity portfolio has been positioned from a style factor perspective as this will provide insight as to how the portfolio will navigate the current market turbulence and how it is positioned to emerge.

Our conviction of the merits of style investing, as well as our success with it over the years, has shown that certain styles – particularly growth and quality as well as momentum – are in the winners' circle in this time of market turbulence. Furthermore, a V-, U- or L-shaped COVID-19 recovery path scenario will produce specific style winners.

Winners through the current turbulence: a style lens

Strategically, our focus is not on which equity sectors will be the winners during a crisis, but rather which style(s), and, hence, companies will be the winners. Our extensive research has shown how specific styles direct investors towards companies that will be the long-term drivers of South African equity returns.

In the first quarter of 2020, at the start of the COVID-19 pandemic, the growth and quality investment styles showed how investors flocked to the safety and resilience of good-quality companies that have been growing their earnings consistently, despite challenging times. This can be seen by growth and quality long/short returns in Figure 1. In this crash, we experienced

a sharp equity sell-off and a prevailing risk-off sentiment. Despite this, and unlike in previous market crashes, the momentum style saw investors flock into trending companies. This can be seen by momentum long/short returns in Figure 1. However, we believe this momentum flight reflects the feature of the momentum style of 'latching on to whatever works', which is similar to how it had latched on to the growth style, which appeared to be working in 2019. The style loser was the value style, as investors were selling off both defensive- and cyclical-value companies in this risk-off environment.

Figure 1: Sector long/short returns

Source: STANLIB Index Investments, Bloomberg

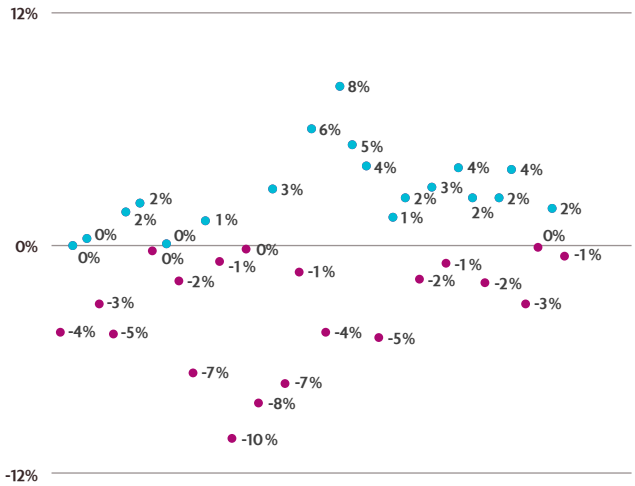
What next? The market direction informs best-performing style

A recovery is bound to happen as investors return to the market, economies regain lost ground, and as the pursuit for alpha returns over defending a portfolio is resumed. This is when lucrative opportunities arise from correctly predicting a V-, U- or L-shaped recovery path scenario and positioning a portfolio's strategy with the appropriate style tilting. Our analysis provides a useful understanding of which style is likely to benefit most from the different types of market recoveries.

- In a V-shaped recovery path (the best-case scenario), where we expect a sharp and relatively fast-paced bounce-back after a market shock, we believe the value style is appropriate. This style tends to perform best in a risk-on environment driven by a positive outlook.
- In a U-shaped scenario, which is similar to a V but takes longer to bounce back after the market shock, we believe the quality style prevails. This style tends to be resilient and performs best in times of uncertainty as investors flock to the safety of good-quality companies.
- In an L-shaped recovery path (the worst-case scenario), where there is a more protracted and stagnant negative impact on future economic activity, we believe the growth style does best. This style tends to reward companies that have been able to deliver earnings growth, despite challenging times.

Even though the pandemonium around COVID-19 has been relatively short-lived so far, interesting patterns supporting our views have already emerged. The Figure 2 scatter-plot depicts the daily returns from 24 February 2020 to April 2020. Figure 3 shows how, by averaging these returns, there is a clear preference during falling markets for quality and growth styles at the expense of value. However, when the market bounced back in April 2020 on renewed positive sentiment, we see a clear preference for the value style, at the expense of quality and growth styles.

Figure 2: Daily returns of Top 40 Index during COVID-19



Source: STANLIB Index Investments, Factset

Figure 3: Average daily performance of L,V and U styles during COVID-19

Source: STANLIB Index Investments, Factset

Applying a macroeconomic lens to guide market direction

We have seen that different styles produce different performances during specific macroeconomic conditions. Our approach has been to identify and forecast these macro conditions using the insights of our proprietary quantitative macro (QM) indicator. Specifically, we have seen that a recovery situation supports the performance of a value style, an expansionary phase supports momentum, a slowdown phase supports quality, and a contraction favours a growth style.

It is important to note that, prior to the COVID-19 crisis, our QM indicator had already forecast a contractionary environment from the beginning of 2019. In Figure 4, we have zoomed into the past four years' forecasts of the QM indicator to explain the different environments it had forecasted and which styles were the winners in each calendar year.

Figure 4: Quantitative macro indicator (past four years)

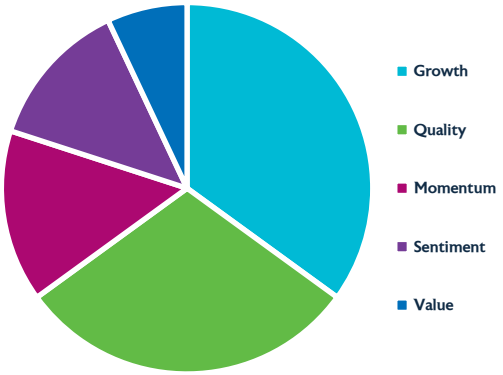
Source: STANLIB Index Investments

In 2020, our QM indicator continues to forecast a contractionary environment, which should be no surprise in the context of the additional strain from the COVID-19 pandemic on economic activity. This contractionary environment tends to favour the growth style, as there is little economic growth, overlapped by increased uncertainty, which also favours the quality style.

Defensive strategy: tilt towards growth and quality

Our QM indicator continues to signal a persistent contractionary macroeconomic environment. As a result, our STANLIB Multi-Factor Fund (see Figure 5) is defensively positioned with our biggest allocation towards the growth and quality styles, and our smallest allocation to value. Companies that currently score highly on this combined style allocation, include Clicks, Naspers, Santam, Vodacom and Capitec, and the fund is, therefore, overweight in these stocks.

Figure 5: Current factor positioning: April 2020



Source: STANLIB Index Investments

Style tilting to weather the storm

Our investment approach to tactical positioning in this environment and to optimise returns over the longer term means it is vital to:

- examine a portfolio's positioning;
- focus on identifying the appropriate style rather than sector to guide asset allocation;
- use robust macroeconomic tools that forecast economic environments; and
- use a rules-based and systematic approach to position the portfolio for a V-. U- or L-shaped recovery path.

Regardless of these unusual circumstances, we continue to rely on our data-driven, rules-based and style-focused investment philosophy to identify and reap rewards from the opportunities that arise. Our analysis above, as well as the success of the STANLIB Multi-Factor Fund, provide proof that style investing in the South African market not only works in defending a portfolio, but also in positioning a portfolio for recoveries. ■

HAS COVID-19 AMPLIFIED OFFSHORE PROPERTY GROWTH TRENDS?

By Senior Equity Analyst, Listed Property
NICOLAS LYLE

Global property is the largest asset class in the world; real estate service provider Savills estimates that investible residential and commercial property assets had a combined value of approximately US$200 trillion at the end of 2019.

There are a number of compelling reasons for including this asset class in a (South African) balanced portfolio, including enhancing performance, managing risk through diversification (asset class, geography and subsector), and managing exposure to the rand.

The asset class has been a dependable performer, delivering 10% annualised returns* in US dollars (more than 15% in rand) over each of the last two decades. Now that COVID-19 has disrupted lifestyles around the world, what does this mean for property growth trends? Can we expect the same performance in future?

In our view, the lower entry point established by the COVID-19-induced correction sets the stage for another decade of double-digit returns. The economic recession will accelerate existing property megatrends and create even more growth opportunities for high-quality companies. The following key megatrends continue to shape the global property landscape and present distinct opportunities.

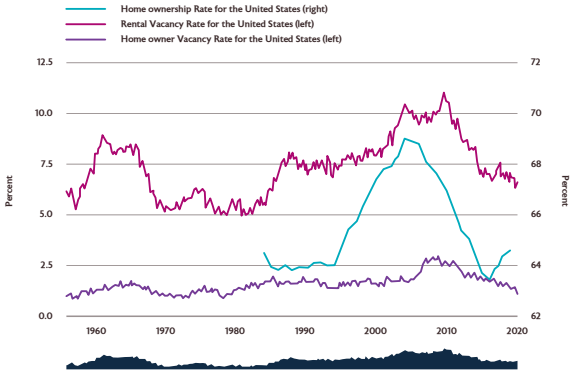
*As measured by the FTSE EPRA/NAREIT Developed Rental Index

Residential: always a necessity

In the US, the rate of home ownership has been declining since the end of the Global Financial Crisis. We believe that it will remain structurally low as generational forces and increased rent regulation will make renting, rather than owning, a more sensible decision for many people. Urbanisation, increasing supply challenges, ownership preferences (especially in Europe) and affordability are all driving the global shift from owning to renting. Demand for institutionally-managed residential property is likely to benefit from structural growth for decades to come.

For example, in the US, the migration of younger generations away from large coastal cities to more affordable but fast-growing cities in the Sun Belt states is likely to accelerate as affordability, flexibility and quality of life are becoming increasingly important criteria.

Home ownership and rental trends in the US



Source: US Census Bureau

Industrial: structural tailwinds

Warehouses, especially those that are logistics-focused, are enjoying a structurally growing wave of demand that is outpacing supply. Specific factors driving demand include:

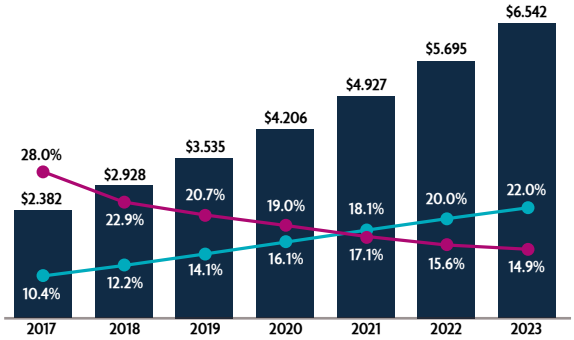
1. **Online commerce:** to achieve a particular turnover target, online businesses require three times more warehousing than physical retail space. In most developed countries, online commerce comprises only 10–20% of overall retail sales but is growing at double-digit rates every year.

2. **Cost rationalisation in supply chains:** driving occupants to move out of older, less efficient warehouses into newer, fit-for-purpose facilities.

3. **More inventory required:** global lockdowns have accentuated the need for warehouses to hold more inventory to ensure stock consistency and speed of delivery.

Retail e-commerce sales worldwide: 2017-2023

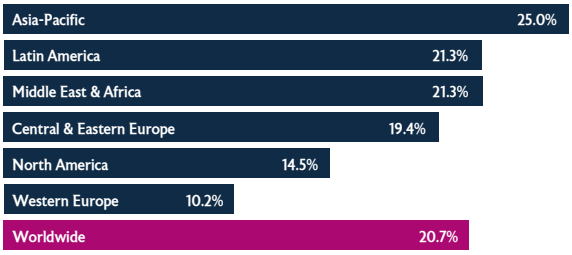
Trillions, % change and % of total retail sales



Source: eMarketer, May 2019

Figure3: Retail ecommerce sales growth worldwide, by region, 2019

% change



Source: eMarketer, May 2019

Note: includes products or services ordered using the internet via any device, regardless of the method of payment or fulfilment; excludes travel and event tickets, payments such as bills, taxes or money transfers, food services and drinking place sales, gambling and other vice good sales.

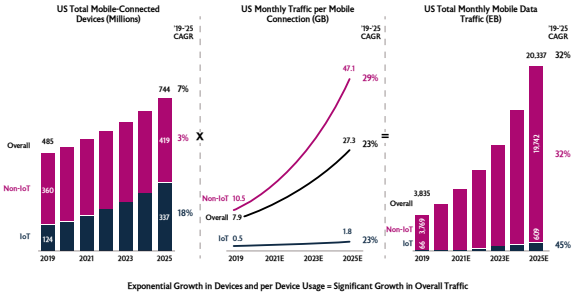
Towers and data centres: plugged into the digital economy

The need for digital connectivity through streaming and storing data continues to grow, driving ever-increasing demand for more bandwidth and faster transmission speeds. The property that houses digital infrastructure as well as the location of this property is becoming ever more critical. Mobile phone towers and network-dense data centres are an essential part of the solution for cloud service providers, content delivery networks, businesses with outsourced IT requirements and many others. Three factors driving longer-term growth in demand for this type of property include:

1. **Cloud storage**
2. **Migration to 4G and 5G**
3. **Edge computing**

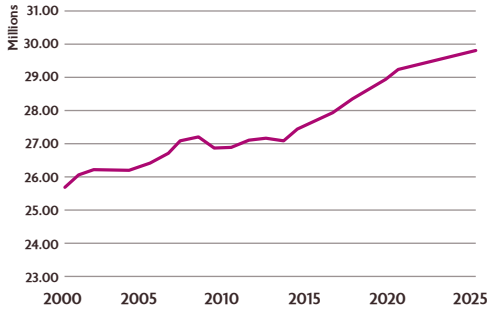
4G continues to catalyse tremendous mobile data usage

US mobile data traffic is projected to continue to grow rapidly



Source: Industry Experts and Martks Analysis

Past and forecast performance: France (millions)



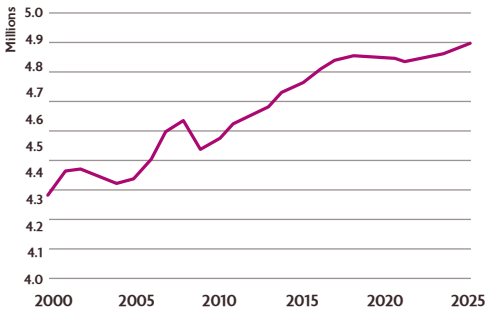
Source: Cedefop

Offices: likely to experience significant change, presenting niche opportunities

Offices represent a major portion of global property investment stock. While we believe that across the world offices are more of a cyclical property subsector, there are some niche markets experiencing consistent demand from strong relative employment growth within more future-proofed industries. These are in cities, such as Toronto, Austin, Miami, Seattle, San Francisco, Stockholm, Paris, Barcelona, Singapore and Hong Kong.

In the right locations, offices should perform more defensively than retail and leisure property over the medium term because of longer leases. Offices needed for certain work activities, social distancing requirements at work, and the fact that office spaces have higher alternative uses than residential, supports this sector. The pandemic may also drive spending on creating a more health-conscious office environment.

Past and forecast performance: Sweden (millions)



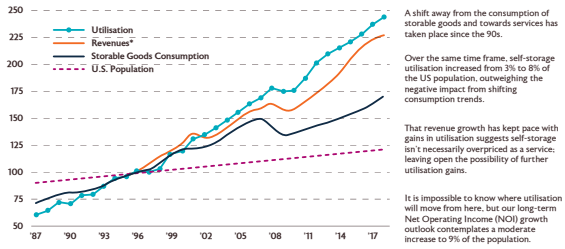
Self-storage: with you wherever you go

Self-storage is a niche property subsector with one of the highest returns on investment (net rental income margins of over 70%). This subsector continues to benefit from long-term growth in utilisation. However, over the short term, the pandemic has put pressure on self-storage REITs with lower or no renewal rate growth, declining move-in rates, greater discounting, and some occupancy headwinds.

The low obsolescence of self-storage, combined with low capital expenditure requirements and low nominal rental payments, will act as a relative buffer against economic headwinds.

Self-storage demand trends

Indexed to '96



Source: US Census, US Bureau of Economic Analysis, Self-Storage Almanac, and Green Street Advisors

Retail property: time for a makeover

Retail property is going through what we believe is at least a decade-long transformation that is likely to be characterised by a sustainable reduction in space needs.

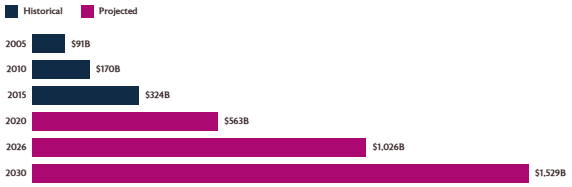
Tenant demand will continue to contract in regional malls (particularly B-quality and below), leading to eventual mothballing as a result of:

- Rapid and sustained **growth of online sales** at the expense of physical store sales;
- Accentuation of **oversupply of retail space** per capita;
- **Reduced rental affordability** as the narrowing of retailers' margins accelerates; and
- **Changes in spending habits** (less time to spend in department stores and more experienced-based spending).

A-grade shopping centres located in densely-populated areas will continue to attract the lion's share of demand and house tenants' flagship, experienced-based stores. These portfolios will benefit from the conversion of low-density retail space as well as the eventual utilisation of air rights (where foundations allow) to become mixed-use assets.

E-commerce growth projections

A.T. Kearney predicts e-commerce will account for a third of US retail sales by 2030



Source: US Census, A.T. Kearney analysis

Looking ahead

We expect the impact of the pandemic to accelerate megatrends within the property sector. Listed property companies most exposed to these trends will continue to outperform in both the short and long term.

We consider sectors, such as data centres, towers, industrial, self-storage and niche residential property as growth sectors, whereas, retail, lodging and hospitality REITs represent value. Global office property lies somewhere between growth and value, depending on its location.

Our investments are, therefore, concentrated in companies owning assets in markets with higher barriers to entry, portfolios that dominate in their niche(s), and companies that have appropriately-geared balance sheets, enjoy cost of capital advantages and have on average higher retention of free cash flow than their peers.

The stock market correction of Q1 2020, the ensuing compression in monetary base rates, as well as the record stimulus provided by central banks have combined to support expansion in the sector. A return to relatively secure long-term income growth from 2021 onwards will provide the runway for another decade of double-digit rates of return. ■

PERFORMANCE AT A GLANCE

MARKET INDICATORS

For the period ending May 2020

May 2020	1 Year	3 Years (p.a.)	5 Years (p.a.)	10 Years (p.a.)
SA Markets	%	%	%	%
All Share (J203T)	-6,0	1,3	2,5	9,7
Top 40 (J200T)	-2,8	2,8	3,2	10,0
SWIX (J403T)	-10,4	-1,9	0,6	9,4
Financial 15	-38,0	-8,2	-5,5	7,3
Industrial 25	3,3	0,1	3,1	15,0
Resource 10	13,4	19,5	6,3	3,3
Property (J253T)	-45,9	-21,6	-11,4	3,5
Inflation (CPI)	4,1	4,2	5,0	5,1
All Bond Index (ALBI)	6,4	8,2	7,7	8,5
Cash (STeFI)	7,0	7,2	7,2	6,5
Offshore Markets (Base Currency)				
MSCI AC World	6,0	5,7	5,9	9,1
Dow Jones US	4,8	9,1	9,8	12,4
S&P 500 US	12,8	10,2	9,9	13,2
FTSE 100 UK	-11,8	-3,0	1,2	5,5
Nikkei 225	8,6	5,8	3,3	10,5
Barclays Global Aggregate (Global Bonds)	5,6	3,5	3,3	2,9
S&P Global Property	-14,4	-1,0	1,1	6,8
3-Month LIBOR (ZAR)	22,7	11,8	8,7	9,1
3-Month LIBOR (USD)	1,4	1,5	1,0	0,4

Source: Morningstar, May 2020

PERFORMANCE AT A GLANCE

STANLIB CORE FUND PERFORMANCE

For period ending 31 May 2020

	Fund	1 Year		3 Years		5 Years		10 Years		Ten-year Annual Returns (%)	
		Return (%)	Quartile	Return (%)	Quartile	Return (%)	Quartile	Return (%)	Quartile	Lowest	Highest
INCOME	STANLIB Income Fund	7,1	4	8,0	2	8,2	1	7,5	1	4,9	10,7
	STANLIB Flexible Income Fund	5,8	2	5,8	4	6,7	4	7,2	3	1,8	13,9
STABLE GROWTH	STANLIB Balanced Cautious Fund	6,7	1	5,7	2	5,6	1	8,5	1	-1,3	16,3
	STANLIB Absolute Plus Fund	3,1	2	4,1	2	5,1	1	8,1	2	-3,9	18,2
GROWTH	STANLIB Balanced Fund	2,1	1	3,9	1	3,4	2	9,2	2	-7,5	26,5
	STANLIB Equity Fund	-2,7	1	2,4	1	1,8	1	10,1	1	-12,8	34,4
	STANLIB Property Income Fund	-44,0	2	-22,6	3	-11,8	3	3,2	2	-47,2	46,7
OFFSHORE (ZAR)	STANLIB Global Equity Fund	30,7	1	19,2	1	14,8	1	17,2	1	-12,6	56,4
	STANLIB Global Balanced Fund	26,4	1	16,7	1	12,8	1	14,5	1	-12,9	37,1
	STANLIB Global Balanced Cautious Fund	24,5	1	14,6	1	10,7	1	11,4	2	-14,9	30,7
	STANLIB Global Property Fund	1,0	3	7,9	3	6,4	2	13,9	1	-19,3	43,5

Source: Morningstar, 31 May 2020

SPOTLIGHT ON

STANLIB INCOME FUND

By Fund Managers
VICTOR MPHAPHULI and
SYLVESTER KOBO

About the fund

Inception:
May 1987

Size:
R45.87 billion

Benchmark:
STeFI Composite Index

ASISA category:
South African Interest Bearing Short Term

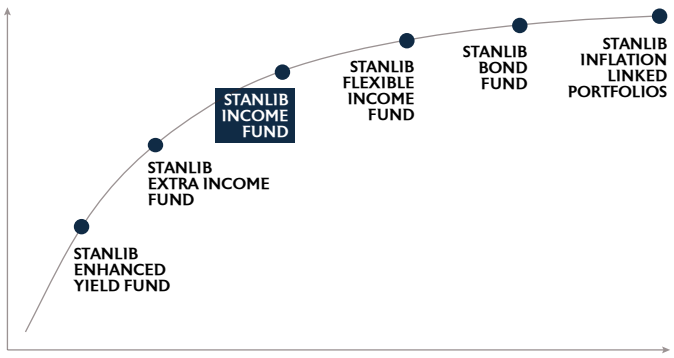
Why invest in this fund?

- **Highly experienced Fixed Income team**
  It is managed by STANLIB's passionate and dedicated Fixed Income team. As one of South Africa's largest fixed-income asset managers, the team has a competitive advantage in negotiating preferential rates when investing.
- **Consistent returns**
  It provides investors with a stable income throughout the business cycle and relatively low capital volatility. This is achieved through a diligent, systematic risk management approach that focuses on consistency.
- **Identifying diverse opportunities to drive performance**
  The fund is actively managed, investing in a range of fixed-income instruments, such as cash, money market instruments and bonds.

Who should invest in this fund?

The STANLIB Income Fund is suited to investors looking to preserve capital while earning a regular income from their investment over the short to medium term, and remaining invested for at least one year. The fund aims to provide investors with stable returns over time and a better return than cash (STeFI Composite Index). To achieve this, it invests in fixed-income assets based on the term of the investment, the yield opportunities and the interest rate and inflationary cycles.

An income solution within our broad range



How we add to performance

Interest forecasts informing portfolio management views

Identifying under and over-valued curve areas

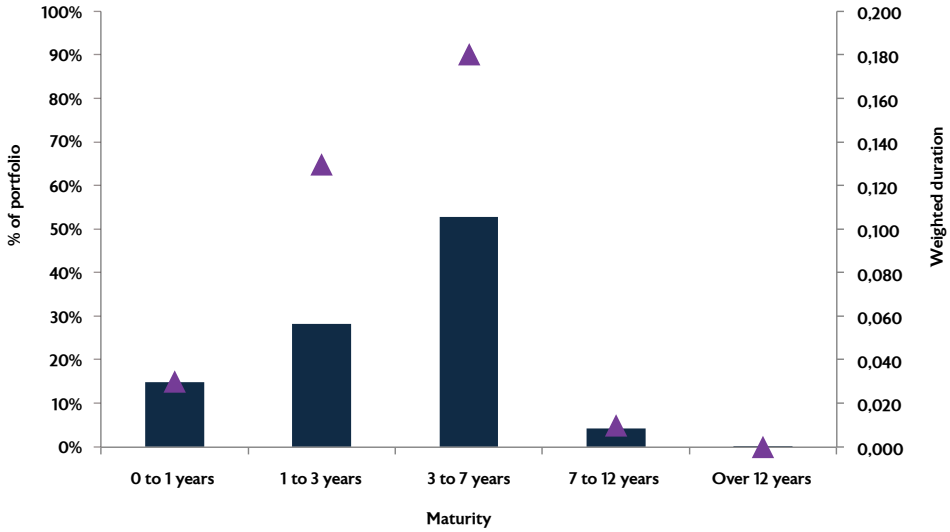
Yield enhancement through carefully-selected credit opportunities

Take advantage of tactical opportunities to add value

Sensitivity to interest rate changes

Duration is a useful measure for managing the sensitivity of capital to interest rate movements.

Chart: STANLIB Income Fund: maturity profile as at 31 March 2020



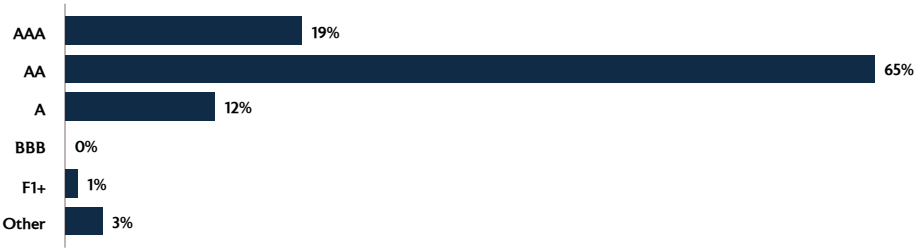
Source: STANLIB research

A low duration and maturity profile protects the fund in uncertain markets; when the risk of credit spreads, moving out becomes higher.

Quality of investments

A key focus of STANLIB's Fixed Income team is on the credit quality of the underlying investments within the STANLIB Income Fund to ensure that, overall, the fund has a high quality of assets.

Chart: STANLIB Income Fund: credit quality as at 31 March 2020



Source: STANLIB research

DISCLAIMER

Collective Investment Schemes in Securities (CIS) are generally medium-to long term investments. The value of participatory interests may go down as well as up. Past performance is not necessarily a guide to future performance. CIS are traded at ruling prices and can engage in borrowing and scrip lending. A schedule of fees and charges, as well as maximum commissions is available on request of the Manager. The Manager does not provide any guarantee either with respect to the capital or the return of a CIS portfolio. The Manager has a right to close a portfolio to new investors in order to manage the portfolio more efficiently in accordance with its mandate.

Portfolio performance figures are calculated for the relevant class of the portfolio, for a lump sum investment, on a NAV-NAV basis, with income reinvested on the ex-dividend date. Individual investor performance may differ due to initial fees, actual investment date, date of reinvestment of income and dividend withholding tax. Portfolio performance accounts for all costs that contribute to the calculation of the cost ratios quoted, so all returns quoted are after these costs have been accounted for. Any forecasts or commentary included in this document are not guaranteed to occur. Annualised return figures are the compound annualised growth rate (CAGR) calculated from the cumulative return for the period being measured. These annualised returns provide an indication of the annual return achieved over the period had an investment been held for the entire period. A portfolio that derives its income primarily from interest-bearing instruments, calculates its yield daily and is a current effective yield.

STANLIB Collective Investments (RF) (PTY) Ltd is authorised Manager in terms of the Collective Investment Schemes Control Act, No. 45 of 2002.

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