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Prudential Inflation Plus Fund: Positioned to deliver inflation-beating returns

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Investors have been experiencing low returns over the last several years from multi-asset low equity funds, as a result of the extended weak returns from local equities and inflation-linked bonds, and more recently disappointing performance from listed property. This is on top of highly volatile markets in bonds and our local currency. As a result of this lengthy period of weak returns we're seeing that investors have been shifting their investments into more conservative income funds from multi-asset low-equity funds, as the latter have been underperforming their real return targets and the more conservative income funds.

Since many retired clients invest a large portion of their income-providing capital in our Prudential Inflation Plus Fund, we've seen how they're struggling to cope with this current "low return world" which managers have cautioned against in the past. In this note we aim to provide some comfort to investors who have experienced an extended period of disappointing returns by sharing our insights into what returns we might expect from the Inflation Plus Fund in the future. **In summary, these returns are likely to be much improved going forward, giving us a strong conviction that the fund should meet its CPI+5% (before fees) return target over time. Patient investors will be rewarded.**

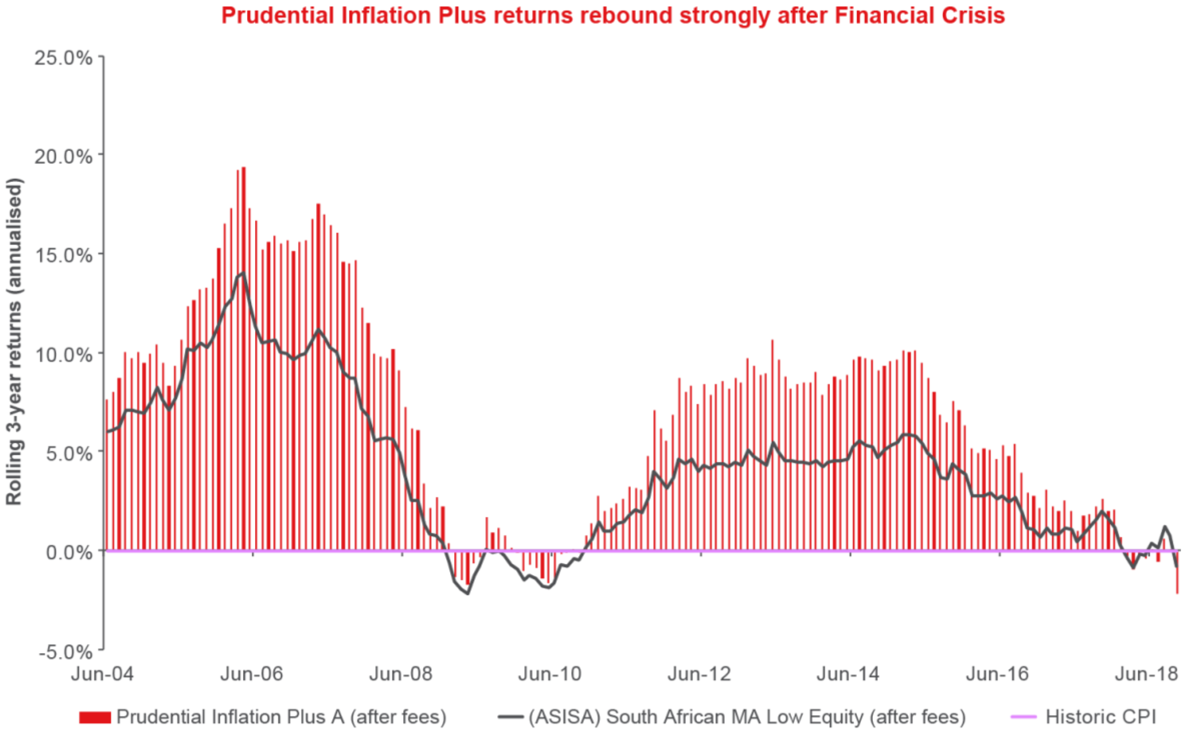
It's important to remember that the fund's objective is to deliver CPI+5% p.a. before fees over a rolling three-year period. As a result, the fund will take on a fair amount of exposure to risk assets in order to deliver on this objective, typically more than many of its peers. Consequently, its short-term returns may reflect relatively higher volatility through the ups and downs of the economic cycle, while over the longer-term delivering on its objective, as we've seen over the fund's history.

As you would know, our investment process is forward-looking and valuation-based. At its heart, we examine current asset class valuations to determine what level of returns they are likely to produce over the next three to five years, and build our portfolios accordingly. We have used this same process for the past 20+ years - it has stood the test of time and consistently delivered inflation-beating returns to our clients over the longer-term. In this note we share our latest valuation analysis, and how this may translate into returns for the fund. We also felt it might be useful to investors if we examined the fund's previous return behaviour in similar conditions in order to draw some insights into what returns we could possibly expect going forward.

Inflation Plus has rebounded strongly in the past

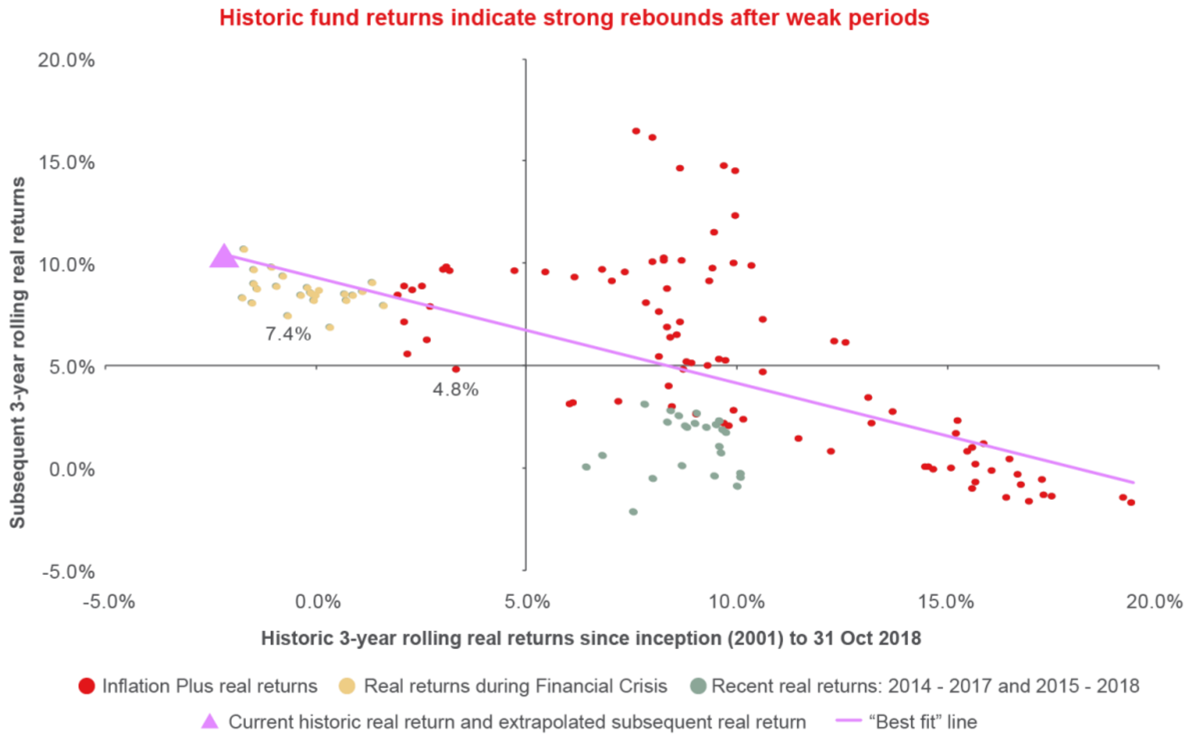
This is not the first time that markets and subsequently multi-asset low-equity funds have delivered disappointing returns for an extended period. For example, the repercussions of the Global Financial Crisis (GFC) saw the Inflation Plus Fund produce negative real returns (below inflation) over rolling three year periods ending between February 2009 and October 2010. During that period we experienced not only equity market collapses around the world and in South Africa, but also losses across bonds and listed property. In the current environment, we are again seeing multiple asset classes trading below their long-term valuations and therefore at attractive levels, but the global economy is much healthier, while our local economy is weaker.

In the graph below we can see that the returns of the entire ASISA category (shown by the black line) came under pressure in 2009-2010, similar to the present (even on a rolling three-year basis), but then rebounded. The Inflation Plus Fund rebounded even more strongly than the category (shown by the red bars). To understand how the Inflation Plus Fund is likely to perform going forward from here, we examined this earlier period of underperformance, particularly in the subsequent periods during which it delivered inflation-beating returns.



Source: Morningstar

The dots in the graph below depict all the historical real returns produced by the Inflation Plus Fund over each rolling three-year period since its inception in 2001 (on the horizontal axis). These are plotted against the subsequent three-year performance for each dot (on the vertical axis). From the data distribution we can see that when historic returns are lower, the fund’s subsequent three-year performance is generally higher, and in fact, the lower the historical real returns, the higher the fund’s later rebound in general. This correlation is illustrated by the downward sloping diagonal “best fit” line (in purple). For example, the returns most impacted by the GFC (all those periods ending in 2009 and 2010) are highlighted as yellow dots, clustered in the upper left quadrant of the graph (and showing historic low real returns followed by higher subsequent real returns).



Source: Morningstar

More specifically, the graph shows that every time the fund delivered a real return of less than 5% p.a. over the preceding three years, all of its subsequent three-year real returns have been very strong at 4.8% p.a. or higher. It also illustrates how, when the fund delivered a negative real return historically (below 0% on the graph), its subsequent rolling three-year real returns have all been at least 7.4% p.a. or more.

As of 31 October 2018, the Inflation Plus Fund's historic three-year rolling real return is now below 0% on the horizontal axis of the graph. The purple triangle indicates where, extrapolating statistically from past performance, the subsequent real three-year rolling return may end up - near the cluster with the GFC returns, well above its CPI+5% return target.

Finally, the grey-green dots depict the fund's strong historic three-year rolling real returns between 2014-2015 of between 5%-10% p.a. (along the horizontal axis); at the same time showing how those periods subsequently produced the real returns we're seeing now (three years ending 2017-2018) of less than 5% p.a.

Based purely on this historic performance analysis we could expect broadly similar results from the fund as market conditions improve. **We would therefore caution investors against switching out of the Inflation Plus Fund now, as they could miss out on such healthy returns.**

Large buffer against bad news built into equity valuations

Key valuation measures indicate that SA equity is priced to deliver healthy prospective returns over the longer term. At these valuation levels, we believe a large buffer against all the bad news that you hear every day in the media has already been deeply embedded into our equity market. If current proposed reforms can even modestly lift our GDP growth from its current very low base, then the potential is genuinely there for equities to produce very good returns going forward, and patient investors will be handsomely rewarded.

- The market's price-to-book value ratio (P/B) relative to history is currently cheap at 1.7x. Historically when the equity market P/B has been 1.7x, it has subsequently produced a five-year nominal return of 19.4% p.a.
- The two most important components of equity returns – dividend yield and real earnings growth – currently have five-year consensus forecasts of 2.9% p.a. and 4.2% p.a. respectively. This amounts to a real return forecast of 7.1% p.a. (or around 12% to 13% on a nominal basis), ignoring any possible market re-rating that would enhance this.
- Prudential's current valuation of the SA equity market points to a real return from equity of 7.6% p.a. over the next five years.

Listed property indiscriminately de-rated

Investors have indiscriminately de-rated the listed property sector across the board, largely as a result of the well-publicised issues surrounding the Resilient group of property companies. According to our valuation based on long-term fair value, listed property is cheap relative to its history and is priced to deliver a real return of 8.1% p.a. over the next five years.

At the same time, it features an attractive forward distribution yield of 9.0% p.a. Approximately 80% of listed property companies are now trading at a discount to their net asset value (NAV), in other words, below the book value of the properties they own. And with approximately 40% of sector earnings coming from offshore, it offers a well-diversified income stream. Even with no earnings growth whatsoever or a re-rating of the sector, 9.0% p.a. would help the Inflation Plus Fund deliver its CPI+5% (before fees) target. Such a decent real return is unlikely to be forthcoming from either cash or bonds over the next five years. Improving growth should provide a supportive backdrop for the sector, although we are very mindful of the headwinds it currently faces given the slow growth environment.

Nominal bond yields compensate for the risk

South African government bonds have been exceptionally volatile in the past few years, hit by “Nenegate”, global risk-averse sentiment and concerns over further sovereign credit rating downgrades, among other issues. At this point we believe these risks are priced into the market and yields on longer-dated bonds in particular – at over 10% (nominal) – are offering ample compensation for the risks involved. According to our long-term fair value analysis they are priced to deliver an attractive real return of around 3.3% p.a. over the next five years, which is well above the historic norm.

Inflation-linked bonds (ILBs) offering highest real yields in 10 years

ILBs represent a significant weighting in the fund (at ±22% currently); the fund relies on them to offer solid protection against rising inflation to meet its CPI-based return target. However, they have produced consistently negative real returns over the past few years, a very disappointing performance, mainly due to the negative impact of lower-than-expected inflation over the period. Now these assets are offering the highest real yields - and therefore the cheapest valuation – in the past 10 years.

Combined with the evidence that the inflation trough has now passed, and that the consensus forecast is for inflation to average 5.0%-5.5% over the next two years, we would only need a modest fall in real yields for ILBs to post good returns going forward. Currently they are valued to deliver a real return of around 2.9% p.a. over the next five years, considerably more than their long-term fair value.

Cash returns likely to deteriorate

Cash is the only local asset whose real returns are likely to deteriorate going forward. Having delivered relatively high real returns through the downturn, we believe they will fall to less attractive levels relative to other assets – to around 2.1% p.a. – over the next five years as the business cycle improves.

Inflation Plus fund positioned to deliver over 5% p.a. real return

Based on these current asset class valuations and the fund's asset allocation, we would expect the Inflation Plus Fund to produce a real return of around 5.3% p.a. before fees over the next five years. The components of this return are shown in the table below.

Asset class	**Expected real returns p.a. (3-5 year view)**
SA equity	7.6%
SA listed property	8.1%
SA govt bonds	3.3%
SA inflation-linked bonds	2.9%
SA cash	2.1%
Foreign equity	6.6%
Foreign bonds	0.6%
Foreign cash	0.9%
Prudential Inflation Plus Fund	**5.3% (before fees)**

In conclusion

Although the Prudential Inflation Plus Fund has underperformed its CPI+5% return target (before fees) over the last few years, we have a high conviction that it is currently well positioned to meet this target over the next three to five years. This is based on the very attractive current valuations across all asset classes apart from cash. Its past performance during similar conditions in the Global Financial Crisis also helps inform our view (recognising that past performance is not an indication of future performance). While we can't predict the future, such as when the economy will start to deliver the conditions necessary for asset returns to recover, we do have the utmost faith in our valuation-based investment process which indicates where returns are likely to be in the next three to five years. This process has delivered consistent longer-term outperformance since 2001. While we acknowledge it is very difficult for investors to do, they need to have patience and stay invested in the fund in order to reap the rewards of the improved returns that are likely as any recovery takes hold.