TABLE TALK

Pieter Hugo, MD of Prudential Unit Trusts, shares his insights into everyday investing issues.

Q

I heard that I should invest in a fund that is well diversified and that can outperform inflation. Are balanced funds a good option?

A

Inflation is basically the rate at which the cost of goods increases over time. As the cost of goods goes up over time, your income or the value of your investments will need to grow by at least the same rate in order to preserve its purchasing power. From an investor's perspective, the most important aspect to consider when it comes to inflation is the long-term impact that it has on the real value (or purchasing power) of your money.

If your investments grow at a rate that is less than inflation, you'll effectively be able to buy fewer goods in the future than you can today. One of your primary long-term investment goals should therefore always be to outperform inflation at a minimum. Ideally, over time your investments should place you in a better financial position than you were previously.

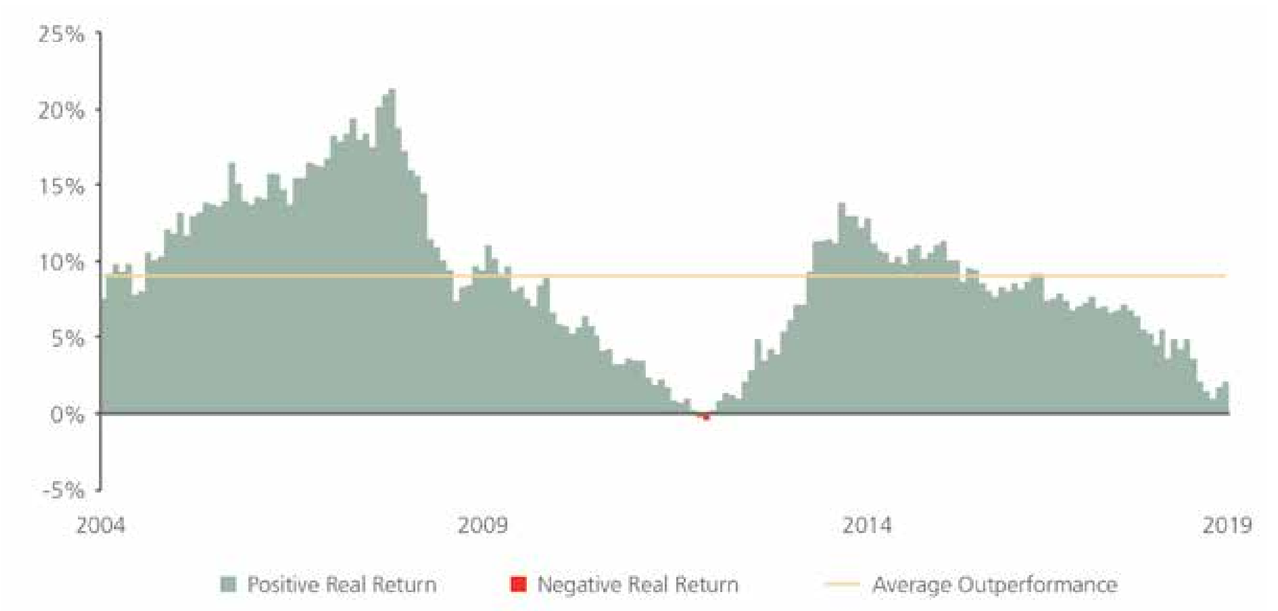
THE BENEFITS OF DIVERSIFICATION

Balanced funds are certainly a good option if you are looking for inflation-beating (real) returns over the longer term (five years or more). These funds give you exposure to a mix of domestic and offshore asset classes (equities, listed property, bonds and cash) that perform differently under different market conditions. Not only does this diversification increase the potential for greater returns, it also reduces the overall risk of the fund.

Another benefit of this approach is that investors don't have to worry about which asset classes to invest in, as the fund managers take on this responsibility. The fund managers' ability to select the appropriate exposure to each asset class and the correct securities within each one is directly linked to the fund's performance. The fund managers also have the flexibility to increase or

IMAGE: SUPPLIED

GRAPH 1: THE PRUDENTIAL BALANCED FUND HAS OUTPERFORMED INFLATION 99% OF THE TIME



Source: Morningstar

Prudential Balanced Fund (A Class) as at 28 February 2019

decrease the fund's exposure to each asset class (within certain limits) as market conditions and asset valuations change, so investors don't have to do this switching themselves.

To demonstrate the benefit of diversification we need only look at the Prudential Balanced Fund. The fund currently holds 24% of its assets in global equities, for example. Holding these assets provides investors with exposure to industries and markets underrepresented on the local stock exchange, and also reduces the fund's exposure to risks inherent in investing in a single country like South Africa, such as currency volatility and political instability.

OUTPERFORMING INFLATION

History has shown that growth assets (such as equities and listed property) have the highest potential to deliver inflation-beating returns over the long term. The trade-off, however, is that having a high exposure to growth assets brings with it an element of risk so that funds can underperform over the short term. Therefore, it's crucial to have an investment horizon that's long enough to see out any short-term volatility to benefit from the long-term growth potential of these asset classes. Currently the Prudential Balanced Fund's combined allocation to growth assets sits at around 75%. The fund also invests approximately 19% in bonds and 6% in cash to help lower the risk of the portfolio while producing income at the same time. We believe this combination of assets in the current conditions should allow the fund to comfortably outperform inflation over the longer term.

Looking at the fund's long-term track record, Graph 1 tracks the rolling five-year returns of the Prudential Balanced Fund since its inception against inflation. Investors can see how the fund has consistently beaten inflation an impressive 99% of the time since its inception. The concept of "long term" is important, as the amount of time that you spend in the fund greatly impacts your investment returns. Balanced funds are typically managed according to an investment horizon of five years or longer; investing for shorter periods not only means that you run the risk of underperformance but you also run the risk of not realising the potential long-term value of the underlying assets within the fund.

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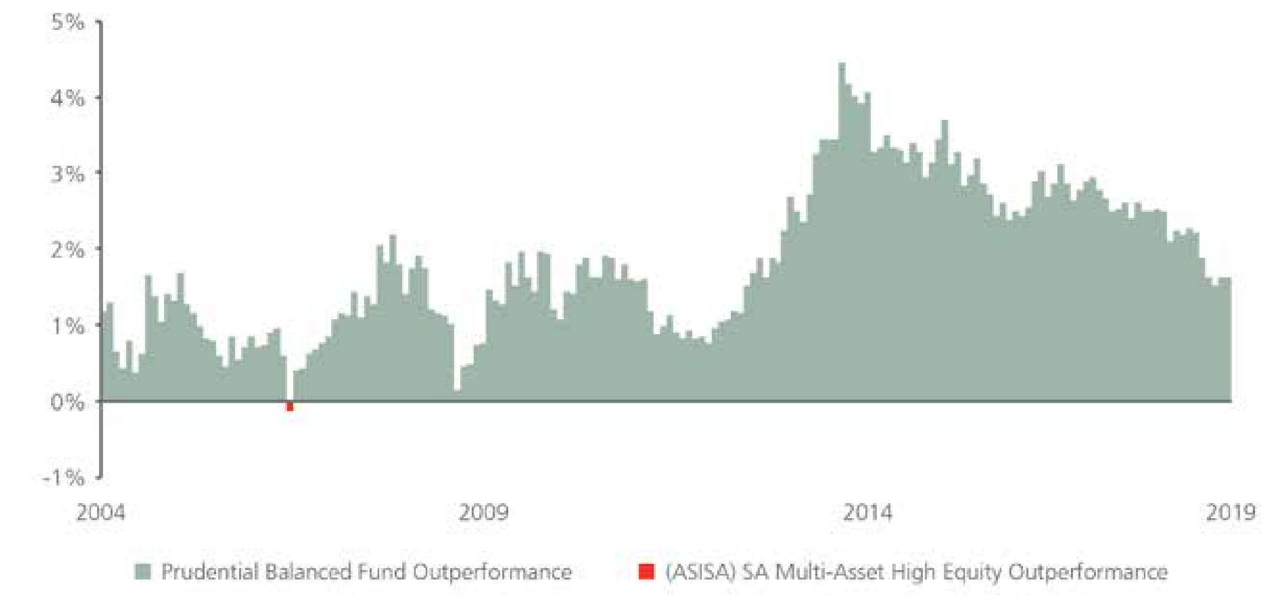
GRAPH 2: THE PRUDENTIAL BALANCED FUND HAS OUTPERFORMED THE AVERAGE OF ITS PEERS 99% OF THE TIME



Source: Morningstar

Prudential Balanced Fund (A Class) as at 28 February 2019

AVOID MAKING SHORT-TERM PERFORMANCE COMPARISONS

When investing, it's easy to get caught up in making comparisons between funds and different asset managers, where you base your decisions on the recent short-term performance of a fund relative to its peers. There are a number of concerns with this approach, one of which is that balanced funds are managed to generate long-term wealth for investors and should therefore be assessed according to their long-term track record.

With this in mind, Graph 2 shows the performance of the Prudential Balanced Fund over a rolling five-year period compared to the performance of the average balanced fund over the same period. What it demonstrates is that the fund has outperformed the average of its peers 99% of the time since it was launched – highlighting the success of our proven valuation-based approach to investing and the consistency with which we manage our funds. This consistent outperformance has placed the fund consistently in the top quartile of its ASISA category – currently over all annualised periods from 1 to 10 years (as at 31 March 2019).

> ***"This consistent outperformance has placed the fund consistently in the top quartile of it ASISA category."***

While both graphs show the successful long-term track record of the Prudential Balanced Fund and its ability to consistently generate inflation-beating returns, it's important to remember that performance doesn't always come in a straight line. Investors should expect that there will be periods where the fund underperforms its benchmark (or inflation for that matter), but over time we strongly believe that the fund is well positioned to meet its objective.

As shown in Graph 1, being able to outperform inflation 99% of the time is an exceptional record and one which we are extremely proud of. In fact, the fund has outperformed inflation on average by 9.0% over a rolling five-year period since inception.

In conclusion, balanced funds are a definitely a good option if your investment objective is to receive inflation-beating returns across a wide variety of market conditions. From an investor's perspective, the trick is to allow the fund sufficient time to deliver on its objectives (five years or more), avoid knee-jerk reactions to market movements and not to fall into the trap of chasing short-term performance.

As the old adage goes, *time in* the market is better than *timing* the market.

IMAGE: SUPPLIED