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FACTORS TO CONSIDER IN VOLATILE MARKETS

Background to markets

2022 has proven to be a very tough year for markets so far. In the US, inflation reached a high level of 8.2% and the Fed has hiked interest rates aggressively this year, raising fears of a recession. Market participants have fled to the safety of cash, and YTD to October 2022 global equity (MSCI All Country World Index) has delivered -21.1% in Dollars and local equity has delivered -5.7% in Rands.

Factors contributing to volatility in markets include the Russia/Ukraine war, the resultant rise in oil, food and gas prices leading to an energy crisis in Europe, the political turmoil in the UK with rapid changes in leadership, and the zero-Covid policy of China choking not only their local economic growth, but also having a negative effect on global growth, reducing the demand for commodities and impacting Naspers and Prosus negatively through their holdings in Tencent.

It is thus no surprise that market prices have fallen sharply over the course of 2022. Importantly though, earnings expectations have not fallen off a cliff, and both global and local equity markets are currently attractively valued. The slightest improvement in one or more of the factors outlined above may easily result in a significant market rally.

Reaction of clients

Against this highly volatile backdrop, clients may be forgiven if they flee to the perceived safety of cash. Some local banks are offering fixed deposits at seemingly attractive yields, but clients need to be reminded of the disadvantages:

- Fixed deposits are typically illiquid investments (typically 5 years fixed deposits are offered at the highest yields).
- Higher rates of income tax is payable on interest.
- Interest rates may be much lower at the end of the 5-year term, posing reinvestment risk.
- Equity markets have already sold off and are currently attractively valued - if clients are locked into an illiquid 5-year fixed deposit they may miss the potential future rally in equity markets.
- Equity markets have mostly outperformed cash over any rolling 5-year period. See Figure 1 below – the ALSI has outperformed cash 83% of the time over any rolling 5-year period, using data for the last 20 years.

Figure 1: ALSI vs Cash: rolling 5 years

Source: Morningstar

Attractive short-term investments

A multi-asset fixed income fund such as the Core Income model portfolio is an attractive short-term investment. It consists of a combination of mostly floating rate notes and cash (and these yields increase as interest rates rise) and smaller percentages of inflation linked bonds, nominal bonds and credit instruments. The fund is highly liquid and offers a current yield of 7.8% at a low duration of 1.3 years (low sensitivity to interest rates).

The Core Income model portfolio has managed to outperform cash over the long term and over any rolling 1, 3 and 5-year period.

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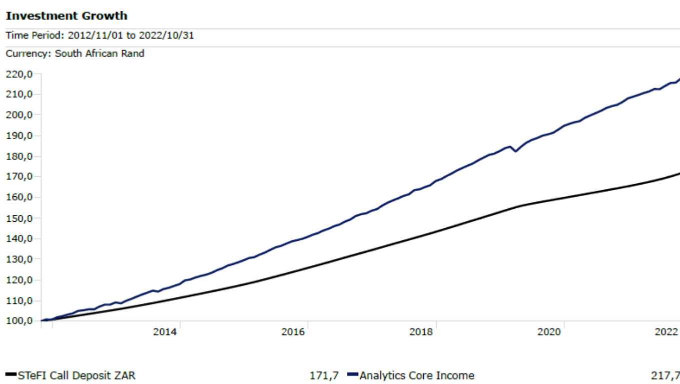
Figure 2: Income Model Portfolio vs Cash



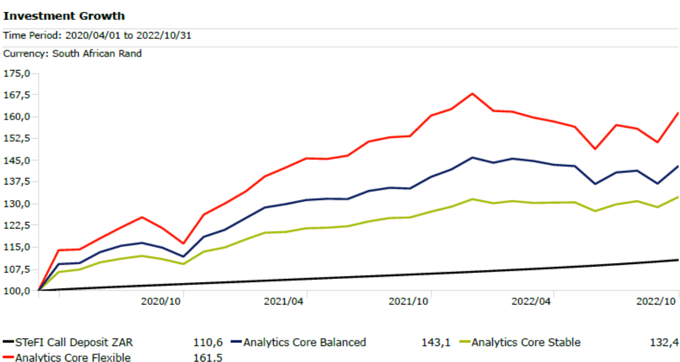
Source: Morningstar

Attractive long-term investments

Multi-asset funds such as the Core Stable, Balanced and Flexible model portfolios are attractive long-term investments. These are highly diversified funds across asset classes and fund managers with different styles that complement each other.

When equity markets rally, these funds with varying exposure to local and global equity outperform cash comfortably. For example, post-Covid the markets rallied, and these funds have managed to outperform cash, even including the poor market performance in 2022 – see Figure 3 below.

Figure 3: Multi-asset model portfolios vs Cash



Source: Morningstar

Food for thought from fund managers

"When investing, money is made in the buying, not the selling. It is the price you pay that matters." *Rory Kutisker-Jacobson, portfolio manager at Allan Gray.*
"If you're prepared, corrections can't hurt you. They are great opportunities to pick up bargains left behind by investors who are panicking." *Peter Lynch, American investor fund manager and philanthropist.*

"Financial assets have already adjusted quite materially. Investors should begin to look where the troughs are, rather than looking for where they can still exit. That is an important mindset change that needs to occur." *Clyde Rossouw, co-head of Quality and portfolio manager at Ninety One.*

"The difference between business owners and investors is that business owners need to be pessimistic when times are tough, while we need to be optimistic." *Karl Leinberger, CIO at Coronation Fund Managers.*

"When there is so much scepticism out there, maybe things aren't actually as bad. We're awfully close to having all the headwinds priced in. The narrative is getting repetitive, and traders are slowly getting fed up." *Gary Bradshaw, portfolio manager at Hodges Capital Management.*

"There is a huge mathematical advantage to doing nothing." *Charlie Munger, vice chairman of Berkshire Hathaway.*

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Closing thoughts

We have a tried-and-tested process for navigating volatile markets. It boils down to understanding and being comfortable with the reasons why markets are behaving in a volatile fashion, ensuring that portfolios are diversified across asset classes, fund managers and styles and staying invested because volatile markets breed opportunities to take advantage of investments at much better prices.

We invite you to speak to your advisor if you have any doubts, fears or uncertainty about the current volatility in markets - they are experienced enough to have weathered many past volatile markets and to realise that volatile and bear markets are inevitable parts of the long-term investment journey.

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Daniel is currently CIO of the Analytics multi-manager funds of funds. He has more than 20 years investment and portfolio management experience, and has previously worked at three of the largest multi-managers in South Africa, first at Investment Solutions, then joined Momentum MultiManagers which later merged with MCubed to form Advantage Asset Managers. His main responsibilities include economic research, tactical asset allocation, investment manager research, portfolio construction, monitoring and risk management, system development and innovative investment research. He is also a member of the Investment Committees of some of the largest advisor networks in South Africa, providing investment consulting services to these groups on an on-going basis.

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