Mid-Year **Review**

2020

10X MID-YEAR REVIEW: **How has Covid-19 affected my finances?**

In this review of the first six months of the year, 10X Investments Chief Executive Officer Steven Nathan focuses on two questions that investors will be asking: How much poorer am I today because of the impact of Covid-19? And, more importantly: How much poorer will I be when I retire?

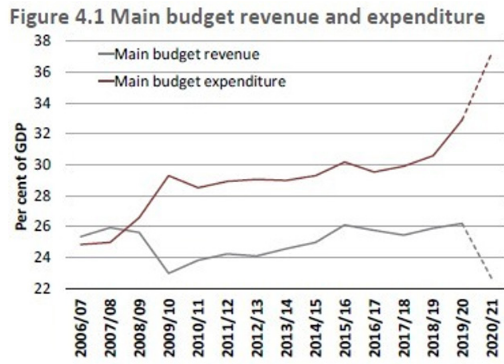
IT IS NOT **ALL BAD NEWS**

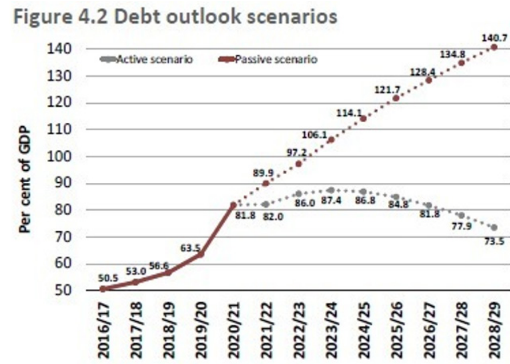
Clearly, the economic environment is bad, not just in South Africa, but globally. Economic growth is going to be very low in South Africa this year, with GDP set to contract by between 5% and 15%. Into 2021, it looks like the economy will still be below the levels of 2019.

The economic shock precipitated by the lockdown has led to many businesses reducing operations or closing altogether, and unemployment rising significantly. A large projected tax revenue shortfall combined with increased spending, as the government tries to offset some of the economic impact through relief measures, will see South Africa's large budget deficit balloon from around 7% to more than 15% in the coming year. The difference between what the government earns and what it spends needs to be financed through debt, with debt-to-GDP set to rise above 81% from below 64%.

In summary, the local macro-economic picture is very poor, and the rand has sold off significantly over the last 6 months, reflecting this bleak outlook.

Figure 1: How does SA finance the increasing budget deficit?





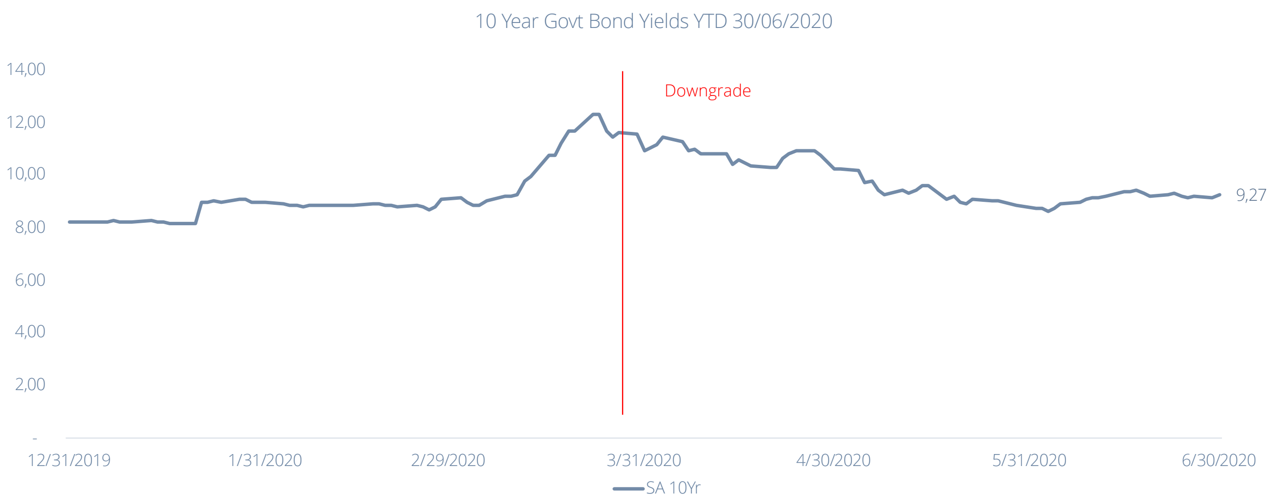
Source: National Treasury

The weaker rand means that a lot of our imports become more expensive, although this has not yet been felt, given the large disinflationary effect of a big fall in the oil price. Despite the rand selling off significantly the rand price of oil and, as a result, the petrol price fell significantly through April and May, providing some relief.

The soft inflationary environment, with May CPI coming in at 2.1%, provided scope for the South African Reserve Bank to aggressively cut the Repo Rate by a cumulative 2.75% to 3.75%, which is the lowest level since its introduction in 1998. The lower interest rate, coupled with lower inflation, softens the economic blows of the lockdown and is a windfall for those not impacted.

During all of this, Moody's finally downgraded South African sovereign debt. The downgrade was largely a non-event, with government bond yields at a similar level to where they were in January.

Figure 2: SA downgraded to sub-investment grade



Source: 10X Investments; Refinitiv Datastream

A weak rand can be seen as a positive in the sense that it makes South African exports better value. Coupled with much-spoken-about economic reforms, this could make South Africa more competitive both in terms of the cost of exports and as a place to do business.

Finally, there has been timeous and significant global monetary and fiscal stimulus. Governments around the world have been providing direct economic relief to citizens through multiple mechanisms including direct grants, whilst central banks have been easing monetary conditions by lowering interest rates.

The increase in spending, together with an accommodative monetary environment should create a higher growth environment to offset the impact of the lockdown on the global economy. It has the potential to stimulate global commodity and resource prices, where South Africa would be a beneficiary.

So, undoubtedly, the environment is negative, but there are some positive takeaways.

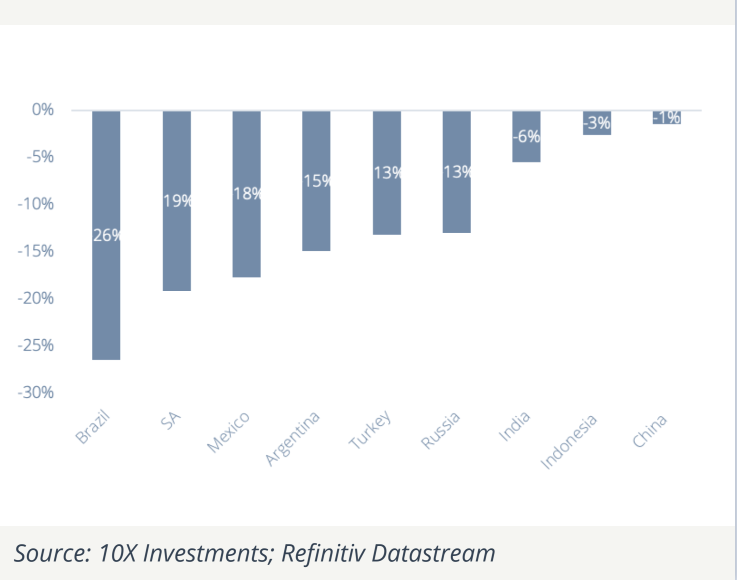
VOLATILITY ACROSS THE GLOBE

As mentioned previously, the rand has been under enormous pressure this year. For the year to the end of June, the rand weakened by 19% against the dollar.

Whilst this performance was poor, it was in line with other Emerging Markets. Brazil was down 26%, Mexico down 18%, Argentina down 15%, Turkey and Russia down 13%. Whilst hard hit, this was not a South African story.

Despite all the challenges in South Africa, a lot of what happens in South African financial markets is determined by the global sentiment towards Emerging Markets. At times of crisis, uncertainty and poor economic growth, investors tend to flee Emerging Markets. We are in that bucket so we see the financial impact thereof.

Figure 3: EM Currencies vs USD YTD 30/06/2020



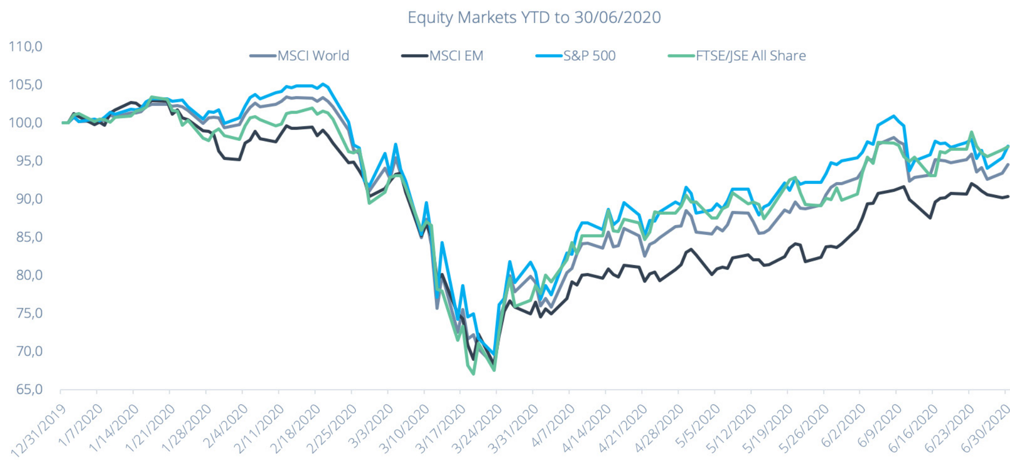
Source: 10X Investments; Refinitiv Datastream

Looking at the performance of equity markets, there were some very tense moments during this period. In March, markets around the world fell by 30%. It didn't matter whether you were in the US market or in South Africa, markets fell by about 30%, sometimes a little bit more.

BIG RECOVERY ACROSS ALL MARKETS

Thankfully, by the end of June, most markets had recovered. The JSE is down about 3% since the beginning of the year. In dollar terms, the US was down 2%, Developed Markets as a whole are down about 5% and Emerging Markets are down 10%. All of these equity markets have recovered significantly from being down more than 30% at the lows during March.

Figure 4: Equity Markets YTD to 30/06/2020



Source: 10X Investments; Refinitiv Datastream, Total Returns

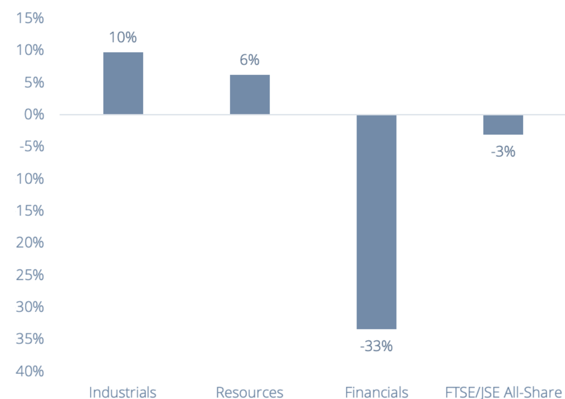
Looking at the JSE, there has been a big dislocation between the rand hedge companies and the domestically focused South African companies.

The Industrial sector is up 10%, but that has been driven by the likes of Naspers, British American Tobacco and other companies with rand hedge qualities.

The Resources sector is up 6% with gold shares shining over the last 6 months.

The Financial sector, down 33%, is closely linked to the domestic economy. The banks are leveraged plays on the economy and the domestically focused shares have done much worse, reflecting the negative local environment.

Figure 5: SA Equity Sector Returns YTD



Source: 10X Investments; Refinitiv Datastream, Total Returns

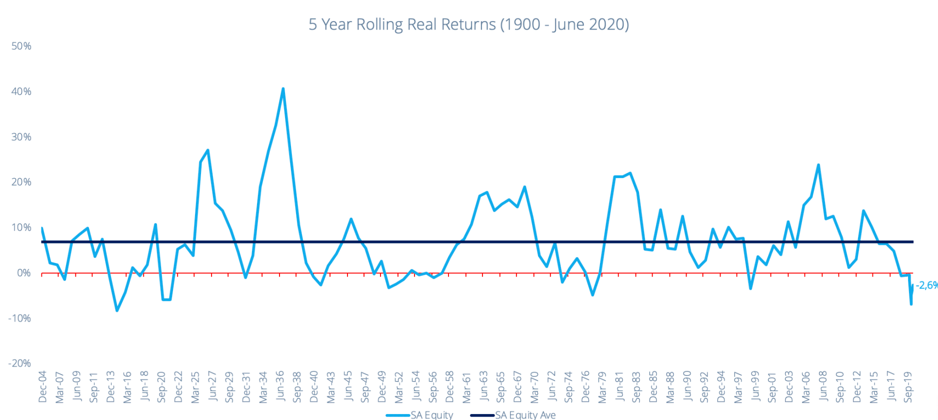
The above performance is evidence of the diversification within the JSE. We are very fortunate as South African investors to have a local stock market that is not really local. Today, more than 60% of the market capitalisation of the JSE has rand hedge characteristics, which acts as a shock absorber when the local economy comes under pressure.

Markets have recovered, but the returns over the last 5 years are still relatively low compared with what we have become accustomed to and compared to offshore markets. In figure 6, below, we compare current 5-year real (after-inflation) returns with other 5-year periods in history. Over the long run, the real return – the return above inflation – from SA equities has been around 7%. If inflation is 5%, you are getting 7% plus 5% i.e. 12%, which is a very good long-term return.

The 5-year real returns are negative. That is a very poor performance, but it is not something that is totally unexpected. It is also not something we haven't seen before in South Africa. We saw this in 1998, and we also saw this in the late 70s, and the returns after both those periods were very positive.

Over the medium to long term, equities have recovered after periods of poor performance and have rewarded patient long-term investors. The expectation would be that we see a similar outcome in SA, maybe not as high as we have had in the past, but we would expect these real returns to turn positive and be above those of defensive asset classes like cash and bonds.

Figure 6: SA Equities - Have we been here before?



Source: 10X Investments; Morningstar, Refinitiv Datastream; Annual Returns 1900-2019, Monthly Returns 2020

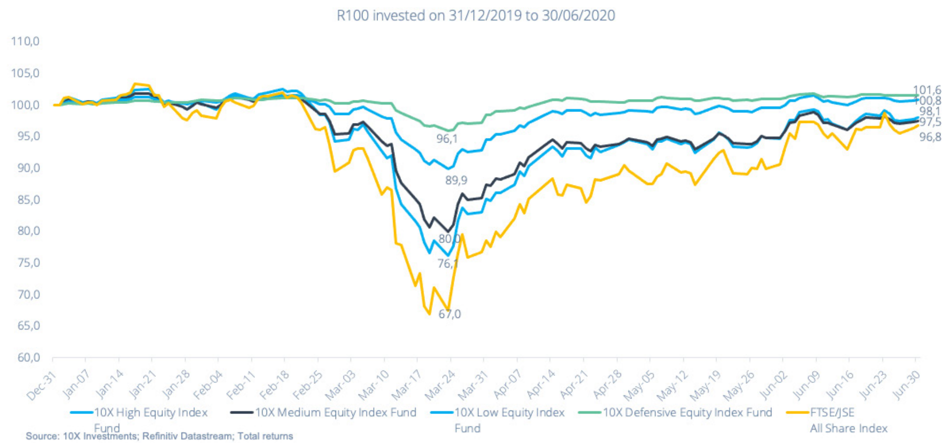
10X PORTFOLIOS: **PERFORMING AS THEY SHOULD**

10X clients are invested according to their time horizon, so different clients will have different portfolios and different expectations of their long-term performance, as well as different experiences during the first six months of 2020.

When equity markets fell in March, the 10X High Equity portfolio fell around 24%, the 10X Low Equity (-10%) and the 10X Defensive (-4%) portfolios fell by significantly less. The portfolios behaved as they are designed to behave, given how the market was performing at the time.

The good news is that to the end of June the portfolios have recovered significantly. The 10X Defensive and 10X Low Equity portfolios have positive returns for the year. The High and Medium Equity portfolios are down about 2%. Given the challenging economic environment these are satisfactory outcomes for the first 6 months of the year.

Figure 7: How the 10X portfolios performed



Source: 10X Investments; Refinitiv Datastream; Total returns

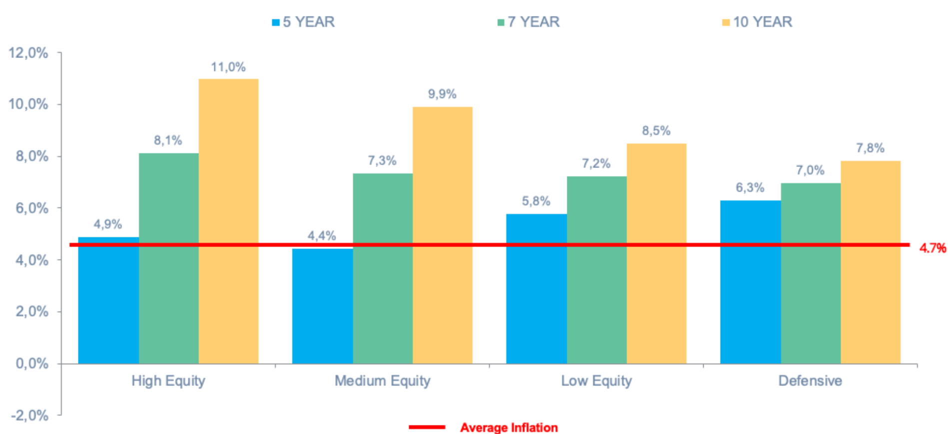
In South Africa, the 5-year returns in the 10X High Equity portfolio have been disappointing at just below 5% per annum over five years. The 10X Low Equity and 10X Defensive portfolios have done better over the last 5 years.

This talks to the fact that, over five years, equity returns have been lower than bond and cash returns. We wouldn't expect that to continue over the long run.

If we look at 10-year returns, which is more relevant to long-term investors, we can see that the 10X High Equity portfolio has returned a very satisfactory 11% per annum over 10 years, including the impact of Covid-19. Bearing in mind that inflation over five years is below 5%, that is a real return of more than 6% per annum, in line with our longer-term expectations of real returns of 6.5% from the 10X High Equity portfolio.

Answering the first question we posed at the beginning of this report (How poor am I?), the answer is: We are not as wealthy as we were at the beginning of the year, but the worst you are probably off is 2%, or maybe 3%, from the beginning of the year, which is satisfactory given the environment that we find ourselves in.

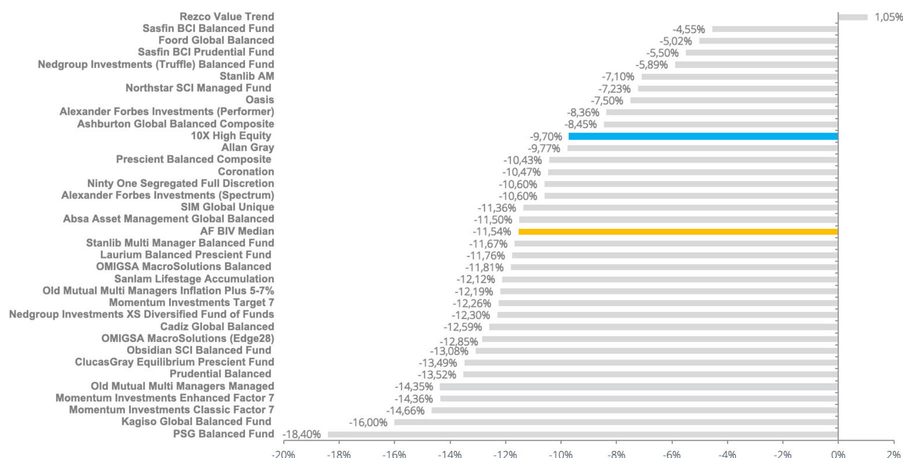
Figure 8: Portfolio returns to June 2020



Source: 10X Investments. Performance is total return (capital change plus income).
Returns greater than 12 months are annualised

PERFORMANCE AGAINST PEERS:
BETTER ON THE WAY DOWN, BETTER ON THE WAY UP

Figure 9: Best investment view - March 2020



Source: 10X Investments; Alexander Forbes Global Manager Watch - Best Investment View Survey, March 2020

Figure 10: Best investment view - April 2020

Source: 10X Investments; Alexander Forbes Global Manager Watch - Best Investment View Survey, April 2020

When the markets fell substantially in March, active fund managers had the opportunity to live up their promise of being able to see when markets were crashing and protect their clients. They have been telling clients they will do better when markets fall “unlike index funds”, which they claimed would take the full market impact.

That didn’t happen in March. The average High Equity portfolio of large active managers fell by 11.5% in March; 10X High Equity fell by 9.7%. Most portfolios were down significantly, but the 10X portfolio fell by considerably less than the average large manager.

In April, when the markets rebounded sharply, the average large manager’s portfolio rose by 9.9%, and the 10X High Equity portfolio rose by 11%. We did relatively better on the way down and on the way up, even before taking into account our lower fees.

This talks very strongly to 10X’s long-term value proposition of owning a sensible and well diversified portfolio linked to your time horizon, tracking the market and paying low fees.

We are proud of how we have performed relative to most active managers and hope you are too as a 10X client. What matters, however, is long-term performance. The short-term performance is vanity; long term performance is sanity.

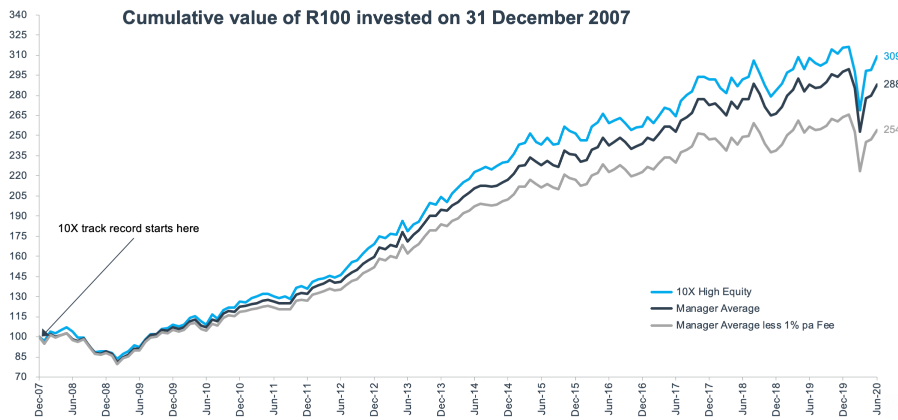


Figure 11: Cumulative value of R100 invested on 31 December 2007

Source: 10X Investments; Alexander Forbes Global Manager Watch - Best Investment View Survey, Dec 2007 - May 2020

Our clients will be familiar with the chart above, figure 11, where we go back to when we started to manage money for clients at the beginning of 2008. It shows how R100 invested in the 10X High Equity portfolio through to the end of June this year would have performed. That R100 would have grown to R309 with 10X, against R288 with the average large fund manager.

Once again, this is before fees. For most of our corporate clients we are saving about 1% in total fees so, comparing apples with apples, the number would be R309 with 10X and R254 with the average large manager.

With this graph we can start to see a long-term picture. We can see the volatility of performance over the short-term, but also that over the longer term the volatility tends to iron itself out and to work its way through our portfolios and retirement plans.

We can see that in 2008 the market fell very significantly in a crisis that lasted longer and was more severe than what we have experienced this year. But in the long run it has faded in most of our memories. It does not look that significant in the long-run performance although it felt terrible in the short run.

Our expectations are that this very challenging period would be of a similar nature in the long run. The good news for 10X clients is that the portfolio's performance is very competitive against the peer group, and they are getting that performance at a much lower low cost.

HOW MUCH POORER AM I LIKELY TO BE AT RETIREMENT?

As we all know, no one knows what the future holds so we approach any outlook with caution and focus on the long-term principles that will help our clients have the best chance of meeting their long-term investment goals.

The outlook is important to us because it talks to the second question we set out to address in this report: How much poorer am I likely to be at retirement because of Covid-19?

It is important to remember that how much money we have at retirement involves many factors, of which investment performance is just one. The first factor is how much are we saving. It is critically important to ensure that we are saving adequately and, hopefully, even increase our savings over time.

If you look at the current environment, a lot of people are paring back their expenses. Some of us may even have more disposable income in the short run because we are being forced to cut back on our expenses. Not only does this mean there is more money available to save, it also reduces our expense base, which can reduce future expectations of how much we will need at retirement. That can help to balance our retirement savings and budget far better.

It is critically important not to cash in those retirement savings along the way. It is so easy to do that in short run but in the long run that limits one's ability to retire comfortably.

Then it is about the fees you pay. That 1 or 2 % extra does not seem significant in the short run, but that 1 or 2% extra can mean between 30 and 60% less money when you retire.

Performance comes on top of that. We really want to get all of these things right. They are ands and not ors.

AS ALWAYS, **FOCUS ON THE THINGS YOU CAN CONTROL**

From an overall portfolio perspective, we would expect the medium to long-term returns, that is 3-5 year returns, to be better than we have experienced in the last 3-5 years, and more in line with the longer term.

We can't guarantee that, however, and we can't influence that directly ourselves. Investors should focus on what they can influence: investing according to their time horizon, minimising fees, and saving as much as they can.

10X Investments manages over R13bn in assets for industry-leading clients

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