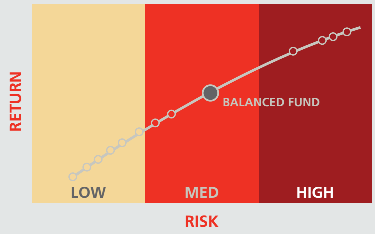
PRUDENTIAL BALANCED FUND
31 DECEMBER 2019

PRUDENTIAL INVESTMENT MANAGERS

MULTI-ASSET

RISK/RETURN PROFILE:



FUND MANAGERS:
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ASISA CATEGORY:
South African - Multi-Asset - High Equity

BENCHMARK:
ASISA South African - Multi-Asset - High Equity Category Average

INCEPTION DATE:
2 August 1999

FUND SIZE:
R22 296 575 921

QUARTERLY COMMENTARY

MARKET OVERVIEW

The year ended on a high note for global equities as investors were able to breathe a sigh of relief on the back of a firm Phase 1 trade agreement between the US and China in December, as well as a decisive Tory victory in the UK's snap general election that paved the way for a less-uncertain Brexit. These December developments helped to improve sentiment towards global growth in 2020, as did the backdrop of easy monetary policy put in place by major central banks.

US equity markets reacted by reaching fresh record highs in late December, while global equities recorded their best annual gains since 2009. Emerging market equities outperformed developed markets after a long period of underperformance. Global bonds, meanwhile, produced marginally positive returns in Q4 as yields drifted higher, as the US Federal Reserve (Fed) signalled in October it was not likely to lower interest rates further and left rates on hold at its 11 December meeting. South African investors also benefitted from the bullish global sentiment, outweighing largely negative local developments as both local equities and bonds delivered positive returns for the quarter, and the rand gained ground against all three major currencies.

In US$ terms, global equities (the MSCI All Country World Index) returned 9.0% for the quarter, while developed markets delivered 8.6% and emerging markets produced 11.8%. Finally, global bonds (Bloomberg Barclays Global Aggregate Bond Index in US$) delivered 0.5% for the quarter and global property returned 0.8%.

In Q4, along with its 25bps rate cut in October and unchanged stance in December, the US Fed strongly suggested that no further cuts were likely for the foreseeable future, and its December "dot plot" forecast pointed to no changes through 2020 and one 25bp rate hike in 2021. The Barclays US Treasury Index produced -0.8% for Q4 in US$. In the equity market, the S&P 500 returned 9.1% for the quarter, the Nasdaq delivered 13.0% and the Dow Jones Industrial produced 6.7% (all in US$).

In the UK, stocks and the pound sterling rallied after PM Johnson's Tory party won a resounding majority in Parliament in the snap general election on 12 December. This set a clear path toward Brexit on 31 January, alleviating much uncertainty. The FTSE 100 returned 10.4% for the quarter in US$.

In the Eurozone, Q3 GDP growth was revised upward to 1.2% y/y, higher than expected and unchanged from Q2, while inflation rose to 1.0% y/y in November from 0.7% y/y previously. Christine Lagarde, the ECB's new President, kept interest rates on hold at its December meeting and confirmed that its bond buying stimulus programme had re-started on 1 November. Germany's DAX produced 9.6% for the quarter and the French CAC 40 delivered 8.6% in US$.

Japan's growth continued to decelerate in Q3 2019 to only 0.2% y/y from 1.3% y/y in the previous quarter as its export-driven economy was hit hard by the US-China trade war and weak business and consumer sentiment. The Bank of Japan left its key interest rate on hold at -0.1% in both October and December, but signalled it could implement more stimulus measures. The Nikkei 225 returned 8.3% in Q4 in US$.

The Chinese economy also continued to slow, posting 6.0% y/y GDP growth in Q3 2019 after 6.2% y/y previously. However, this could start to turn around – albeit slowly – from 1 January when Phase 1 of the US-China trade agreement takes effect. Hong Kong's Hang Seng Index returned 9.1% in Q4 and the MSCI China returned 14.7% in US$.

Among other emerging markets, the strongest equity performance for Q4 in US$ came from the MSCI Russia with a 17.1% return, while Brazil's Bovespa posted 14.3% and the MSCI South Africa 13.2%. The weakest market was the MSCI Turkey, which was flat.

South Africa benefits from global rally

Positive global investor sentiment lifted South African assets and the rand in Q4, helping to offset further negative developments locally. These came in the form of a bearish, but realistic, Medium-Term Budget Policy Statement (MTBPS) in October which pointed to slower growth and a rising government debt burden. This was greeted with alarm by the markets and credit rating agencies, with both S&P and Moody's lowering their credit outlook on SA sovereign debt to negative. Then the resumption of load-shedding in December and the possibility of it extending well into 2020 added further to the gloom, given the negative impact it will have on growth going forward.

As expected, the SARB kept interest rates steady at its November MPC meeting, saying the risks of rand weakness and slow growth outweighed the subdued inflation environment (at only 3.6% in November, a nine-year low). The central bank's model is forecasting one 25bp interest rate cut in Q3 2020.

SA bonds came under selling pressure earlier in the quarter amid the backdrop of rising government debt levels, slower growth and a deteriorating credit rating outlook. However, this was offset to some extent in December by increased demand among investors looking for attractive real yields, as local bonds offered among some of the highest real yields in the world. The BEASSA All Bond Index managed to deliver 1.7% in Q4. SA inflation-linked bonds returned -0.9% over the three months, while cash (as measured by the STeFI Composite) delivered 1.7% in Q4.

SA equities were buoyed by the improved global growth outlook and "risk-on" sentiment in Q4, which underpinned technology stocks and resources companies in particular. This made for a relatively narrow rally

ANNUALISED PERFORMANCE	A CLASS	BENCHMARK	T CLASS	X CLASS	B CLASS
1 year	8.8%	9.5%	9.3%	9.1%	9.6%
3 years	5.5%	5.1%	6.1%	6.9%	6.3%
5 years	5.8%	4.8%	n/a	6.1%	6.6%
7 years	9.1%	7.3%	n/a	n/a	9.9%
10 years	10.4%	8.4%	n/a	n/a	11.3%
Since inception	13.2%	11.4%	5.6%	8.8%	13.8%

Inception dates: X Class: 2 January 2013, B Class: 1 July 2002, T Class: 2 January 2015

ASSET CLASS RETURNS	TOTAL RETURN: Q4 2019 (RAND & US$)	TOTAL RETURN: 2019 (RAND & US$)
SA equity – FTSE/JSE All Share Index (Rand)	4.6%	12.0%
SA equity – FTSE/JSE Capped SWIX All Share (Rand)	5.3%	6.8%
SA listed property – FTSE/JSE All Property Index (Rand)	0.6%	1.9%
SA bonds – BEASSA All Bond Index (Rand)	1.7%	10.3%
SA inflation-linked bonds – JSE CILI Index (Rand)	-0.9%	2.6%
SA cash - STeFI Composite Index (Rand)	1.7%	7.3%
Global equity – MSCI All Country World (Total) (US$ net)	9.0%	26.6%
Global equity – MSCI World (Developed) (US$ net)	8.6%	27.7%
Global equity – MSCI Emerging Markets (US$ net)	11.8%	18.4%
Global bonds – Bloomberg Barclays Global Aggregate Bond Index (US$)	0.5%	6.8%
Global property – FTSE EPRA/NAREIT Global Property REIT Index (US$ net)	0.8%	23.0%

Source: Prudential, Bloomberg, data to 31 December 2019

Sources: Prudential, Morningstar & Deutsche Securities for the local equity market, where Naspers and resources companies (to a lesser extent) have significant weights. The FTSE/JSE ALSI returned 4.6% for the quarter, with Resources returning an impressive 13.5%. Financials delivered 2.8%, Listed Property (SAPY) produced 0.6% and Industrial counters were flat. The FTSE/JSE Capped SWIX All Share Index, which we use as the equity benchmark for most of our client mandates, returned 5.3%.

Finally, the rand rallied against all three major currencies in Q4, along with most other emerging market currencies. It gained 7.6% against the US dollar, 0.9% against a much stronger pound sterling and 4.9% versus the euro.

PERFORMANCE

The fund returned 2.2% (after fees) for the fourth quarter of 2019 and 8.8% for the 12-month period ending 31 December 2019. The fund has delivered a return of 13.2% per annum since its inception in 1999 (after fees), compared to its benchmark of 11.4% per annum over the same period.

The largest asset-class contributor to absolute performance for the period was the fund's exposure to SA equities, followed by international equity holdings. Other positive contributions came from SA nominal bonds and SA cash. Minor detractors were the fund's holdings in international fixed income and cash.

In terms of specific equity exposure, the fund's holdings in Implats, Sasol, Anglo American and British American Tobacco were the strongest equity contributors to absolute returns for the quarter, with smaller contributions from Amplats, Remgro, Sappi, Exxaro and Quilter. Detracting from absolute returns were holdings in MTN, PPC and Prosus.

STRATEGY AND POSITIONING

During the quarter we reduced our overweight exposure to global equities in response to the strong market performance, and on the back of a year of high equity market returns which were not matched by the same extent of improvement in the global macroeconomic environment. However, because the global equity risk premium on offer remains substantially above both historic norms and global government bond yields, we remain overweight global equities. The fund's total offshore exposure remains at around 25%.

In **global fixed income**, US government bonds became somewhat cheaper during the quarter, but remain cheaper than other developed markets like the UK, EU and Japan, where a wide range of government bond yields are in negative territory. Consequently, the asset class remains unattractive versus equities. We are underweight global sovereign bonds and underweight duration, preferring to hold investment-grade US and European corporate bonds.

For **global equities**, we reduced our overweight position during the quarter, taking profits on the back of the strong equity rally and in light of our view that the global economic outlook is not as robust as that reflected in current equity valuations. However, we have remained overweight as a whole given the very high risk premium from equities versus global bonds. Emerging markets and currencies continue to be especially well valued on many measures, while the US market is relatively expensive - other markets offer better value.

We still prefer the global banking sector, which has underperformed the broader market, as well as certain developed markets where equities are undervalued but fundamentals for earnings growth remain positive, including Germany and Japan. We also find selected emerging markets attractive, including South Korea, Indonesia and China. These overweight positions are financed primarily by an underweight in global bonds, as well as US equities to a lesser extent.

Following December's rally, **South African equities** became marginally more expensive on most valuation measures: during the quarter the 12-month forward P/E of the FTSE/JSE All Share Index rose from around 10.9X to 11.6X and the earnings yield fell from 8.6% to around 8.1% in December alone. However, both are still cheaper than the market's longer-term fair value, in our view. We remain overweight SA equities in the fund and are comfortable with our equity allocation levels. We are cautiously optimistic regarding SA equity market returns over the next three to five years due to the prevailing excessive levels of pessimism reflected in share prices and valuations.

The fund continues to hold resources stocks with exposure to global growth and foreign currency earnings like Anglo American, Exxaro, Sasol and Sappi, as well as global giants such as Naspers and British American Tobacco (BAT). All of these overweights added value to the fund for the quarter, with rebounds for Sasol, Sappi and Exxaro after suffering losses in Q3.

We have also maintained our overweight exposure to financial shares including Old Mutual, Investec plc, Standard Bank and Absa, which offer attractive valuations with relatively high dividend yields. While Investec added value to our house view portfolios for Q4, the latter two counters detracted from value. We believe Investec's unbundling and separate listing of Investec Asset Management from the bank operations set for Q1 2020 should unlock value, as the asset management profits and dividends that were historically trapped in the bank will now be distributed directly to shareholders. The unbundling should leave both the UK and the South African banking operations in a well-capitalised position from which they can grow into the future. With a refreshed management team that is now prioritising returns and addressing sub-optimal businesses, we think returns on equity will improve over time. The demerger should also allow for more industry-focused boards and management teams that could unlock further value.

As long-time holders of Trencor, we believe its unbundling of global shipping container group Textainer during the quarter will unlock value -- both stocks could be substantial beneficiaries of improvements in the US-China trade war going forward. Remgro, another group in which we are overweight, also announced an unbundling of its stake in First Rand for Q1 2020. We believe this is likely to reduce the discount in the share price of the holding company going forward.

Also supporting returns was the rally in Quilter and Capital & Counties shares, thanks to the strong Brexit-related rebound in the UK market. We took some profits in these holdings in December. Later in the quarter Naspers and Prosus shares fell and then recouped some losses after Prosus failed to win a takeover bid for UK-based food delivery group Just Eat in a bidding war – this as the market had considered the bid too costly. Our overweight Prosus positioning detracted from returns for the three months.

Meanwhile, we are still underweight retail stocks like Clicks, Mr Price, Shoprite and Truworths in our house view portfolios, given the pressure under which local consumers find themselves. Strategically, we do have a holding in Woolworths and a small exposure to Pick 'n Pay.

In **SA listed property** we continue to be underweight in the fund given the higher risks to earnings going forward despite the attractive valuations prevailing in the asset class. We remain concerned about the earnings outlook for the sector, as it faces ongoing headwinds arising from pressure on landlords to reduce their rentals, particularly in the retail space where retailers are facing sluggish consumer spending. Equally, oversupply in office space is negative for listed property earnings currently.

We remain modestly overweight in **SA nominal bonds** based on the very attractive yields on offer, particularly in the longer-dated maturities above 10-years where real yields reached 4.5% during the quarter. This is very high relative to most other emerging market bonds, even those with worse credit ratings than ours. It is also well above our long-run fair value assumption of 2.5%. We are comfortable with the compensation bonds offer given the risk involved (such as a Moody's credit rating downgrade).

For **SA inflation-linked bonds**, real yields remain attractive for long-dated tenors. However, we have very little exposure to this asset class as we believe better value exists in SA equity and nominal bonds, where long-dated nominal bonds have the potential to offer more attractive value over the medium-term and are much more liquid. ■

Sources: Prudential, Morningstar & Deutsche Securities