PRUDENTIAL 7% TARGET INCOME FUND
30 JUNE 2021

PRUDENTIAL INVESTMENT MANAGERS

QUARTERLY COMMENTARY

TARGET INCOME

FUND MANAGERS:
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ASISA CATEGORY:
The Fund is unclassified given its unique investment objective.

PRIMARY OBJECTIVE:
7% Income return p.a.

INCEPTION DATE:
2 April 2019

FUND SIZE:
R404 283 971

MARKET OVERVIEW

During the second quarter (Q2) of 2021, more progress in vaccine rollouts worldwide, as well as positive corporate earnings reports and economic news, continued to lift equity returns, particularly in developed markets, even as concerns emerged over high valuations. Bonds – both government and corporate credit – also recorded solid performances, retracing some of their Q1 losses and buoyed by reassurances from central banks that easy monetary policies would not be halted any time soon. It was no coincidence that cheaper, out-of-favour equities like Listed Property were among the strongest performers, while more expensive sectors like Resources underperformed.

Meanwhile, the approval of even more US government spending helped support the global growth outlook, as did improving conditions in the UK and Europe. However, emerging market equities lagged those of developed markets, and South African equities broadly underperformed their EM peers due largely to the market's high Resources exposure, after outperforming in Q1. In contrast, South African nominal government bonds posted strong returns compared to those of many other countries over the three months.

After gaining over 22% in the first quarter of 2021, the spot price of Brent crude oil rose another 18.2% in Q2, for an increase of 45% so far in 2021, fuelling inflation around the globe. As for commodity prices, most were higher over the quarter with the exception of platinum, which lost 7.4%. The gold price gained 4.5% for the quarter, and palladium was up 3.5%, giving it a 40% gain over the past 12 months. Industrial metals were also stronger: nickel rose 14.6%, aluminium 11% and copper 6%.

South Africa

Economic growth surprised to the upside in South Africa as Q1 2021 GDP growth measured 4.6% q/q annualised, notably higher than the 2.5% market forecast. Covid-19 vaccine supplies continued to make their way into the country and the government's vaccination programme made headway, but this progress was overshadowed in June as President Cyril Ramaphosa was forced to reintroduce Level 4 lockdown measures in the face of the spreading third wave of Covid infections.

Meanwhile, the South African Reserve Bank kept its benchmark interest rate unchanged at a record low of 3.5% at its 20 May MPC meeting, warning that slow progress on vaccinations, limited energy supply and policy uncertainty continued to pose downside risks to the economic outlook. This was despite the jump in consumer inflation to 4.4% y/y in April and 5.2% in May, attributed largely to the previous low base. The central bank raised its growth forecasts for 2021 from 3.8% to 4.2%, but lowered its projections for 2022 and 2023 to 2.3% and 2.4% respectively. It is also projecting two 25bps interest rate hikes in 2021.

The FTSE/JSE ALSI was roughly flat for the second quarter, returning 0.05%, while the FTSE/JSE Capped SWIX All Share Index, which we use as the equity benchmark for most of our client mandates, returned 0.6%.The standout sector was Listed Property (the All Property Index) with an 11.1% total return. Financials delivered 7.5% and Industrials eked out 0.8%, but the Resources Index returned -5.0%. This performance reflected the value still seen in "SA Inc" counters, which have lagged during the recovery, and the growing view that Resources shares may be reaching the end of their bull run.

SA bonds posted a strong 6.9% return (as measured by the FTSE/JSE All Bond Index), remaining sought-after sources of yield for global investors compared to many other sovereign bonds. SA inflation-linked bonds produced 3.0% (Composite ILB Index) on the back of somewhat softer demand for inflation protection, and cash (STeFI Composite) delivered 0.9%.

Finally, the rand appreciated against the major global currencies over the quarter, rising strongly from its oversold position in April and May before retracing some gains in June. It gained 3.3% against the US dollar, 3.1% versus the pound sterling and 2.4% against the euro over the three months.

PERFORMANCE

The Prudential 7% Target Income Fund returned 5.9% (after fees) for the second quarter of 2021 and 14.9% for the 12-month period ending 30 June 2021.

The largest asset-class contributors to absolute performance for the quarter were the fund's exposure to SA nominal bonds (by far), followed by SA listed property and SA cash. SA equities and SA ILBs also added value. . There were no detractors to the fund's absolute returns on an asset class basis.

In terms of specific equity exposure, among the strongest equity contributors to absolute returns for the quarter were the fund's holdings in listed property stocks like Growthpoint, Resilient, Redefine, NEPI Rockcastle and Vukile. Other diverse stocks like MTN, Foschini and Richemont also added to returns, as did financial counters like Investec and Old Mutual. Naspers was by far the largest equity detractor from absolute returns, while Resources holdings like Implats and Amplats also weighed on performance.

STRATEGY AND POSITIONING

The fund was launched in April 2019 as a restructured successor to the 7% Prudential Income Portfolio (PIP) range, which had built up a successful track record since 2003. The restructuring was undertaken to improve certain aspects of our PIP range of income solutions to make them more understandable for clients, more efficient from an investment point of view and, where relevant, potentially more tax efficient.

It is important to remember that by definition, the Prudential Target Income Funds are managed as long-term strategies that aim to, firstly, deliver their income requirement, and secondly, grow capital in order to meet future income requirements.

Because of its high 7% income target, the fund has a higher exposure to income assets, such as bonds, and lower exposure to growth assets, such as equity, than the 5% Target Income Fund. Currently around 10% of the portfolio is exposed to local equities, while around 5% is invested in SA listed property, 66% in SA nominal bonds, 5% in SA ILBs and around 15% in SA cash. The fund has no international exposure.

The fund was still overweight **SA equities** in Q2. SA equity valuations (as measured by the forward Price/Earnings ratio of the FTSE/JSE Capped SWIX Index) became somewhat more attractive over the quarter, moving from around 9.7X at the beginning of the quarter to around 9.2X at quarter-end as equity prices moved sideways but earnings expectations rose. This improvement in valuations was insufficient to cause us to change our allocation to SA equity as competing assets also remained attractive.

Within SA equities, in broad terms our exposure to large global companies (in particular Resources groups and Naspers) did not work in our favour over the quarter due to rand appreciation and underperformance from some of these shares. However, our

ANNUALISED PERFORMANCE	A CLASS	CPI	B CLASS
1 year	14.9%	5.2%	15.4%
2 years	4.8%	3.6%	5.2%

Inception date: B Class: 2 April 2019

Sources: Prudential, Morningstar & Deutsche Securities continued overweight to financial stocks added to portfolio value with contributions from Investec, Absa, Standard Bank, Remgro and Old Mutual as notable performers. Other good returns came from listed property stocks, as well as our exposure to retailers like Foschini and Truworths, as well as MTN and Richemont. A large detractor to performance over the period was our holding in Naspers, which was under threat from Chinese regulators and garnered negative investor sentiment regarding its proposed share exchange with associate company Prosus. Our basic resources holdings such as Amplats and Implats also detracted from value.

We have maintained our positioning in **SA listed property** in Q2 2021. Listed property has been the best-performing sector (and asset class) so far this year, recording a 20.1% return over the six months to end-June, but earnings have been broadly flat and the sector's forward earnings yield has fallen from 11.5% to 10.25% due to price appreciation. In our view, although it is encouraging that earnings have not deteriorated further and we may be reaching the end of the downward trend with the current earnings stabilisation, it is still too early to call. Our positioning therefore reflects our belief that risks around property company earnings remain high, combined with the continuing relatively high debt levels in the sector. We have ensured that we are holding high-quality companies with strong balance sheets within our small exposure to the sector, like Growthpoint.

SA nominal bonds enjoyed strong returns in Q2, and the fund benefitted from its overweight exposure to these assets. During the quarter we moved further overweight, switching out of some of our exposure to SA inflation-linked bonds which had outperformed over the period, rendering nominal bonds relatively more attractive. We also remained tilted towards longer-dated maturities, which returned more than their shorter-dated counterparts over the three months (12+-year maturities returned 10.1% in Q2 vs the All Bond Index's 6.9% return). With the yield on the R209 15-year bond ending June at 10.1%, for example, these securities remain attractive relative to other income assets and their own longer-term history. We believe they will more than compensate investors for their associated risks.

We maintained the fund's exposure to **SA inflation-linked bonds (ILBs)** during the quarter. The gap between ILB and cash real yields narrowed on the back of the rally in ILBs as cash real yields were steady, but ILB real yields are still somewhat attractive compared to their own history and our long-run fair value assumption of 2.5%.

Although market volatility remains high in the short term, we believe the fund is well-positioned to meet its objectives over the next three to five years, and we continue to take advantage of opportunities to enhance long-term returns. ■

Sources: Prudential, Morningstar & Deutsche Securities