Sanlam

Sanlam Corporate: Investments

Protection Strategies

Investment Report

Quarter 3 2023

Insurance | Financial Planning | Retirement | Investments | Wealth

Contents

Overview

In order to cater for divergent client preferences, the trustees of the **Sanlam Umbrella Fund** have approved the three **protection strategies** that can be chosen as a default investment strategy at participating employer level depending on the required investment objectives and product option. These strategies provide different levels of guarantees and smoothing of investment returns for our clients.

The protection strategies consist of 3 options which members can invest in. (1) Sanlam Secure Strategy which invests 100% in the *Sanlam Monthly Bonus Fund*, (2) Sanlam Stable Strategy which invest 100% in *Sanlam Stable Bonus Portfolio*, and the (3) Volatility Protection Strategy which invest 75% in *Sanlam Monthly Bonus Fund* and 25% in *Satrix Enhanced Balanced tracker Fund*

Protection Strategies Portfolios

Sanlam Secure Strategy

The trustees have approved an alternative default investment strategy suitable for members who wish to achieve inflation-beating real returns over the medium to long term, but who are particularly concerned against significant short-terms investment losses.

The strategy will most likely result in lower returns than the Lifestage Strategies over the long term as a consequence or the implicit cost the underlying guarantees and lower effective equity exposure. Nonetheless, the trustees recognise that such a strategy is suitable for many members – particularly those members who are not financially sophisticated and who might not appreciate that a high equity exposure inevitably implies some risk of capital loss over the short-term.

The strategy could be considered by investors preferring a cautious approach to money management; investors who require capital security and investors who regard financial security as highly important. The strategy currently invests all contributions in the Sanlam Monthly Bonus Fund which declares fully vesting bonuses with full guarantees.

Sanlam Stable Strategy

The trustees have approved an alternative default investment strategy, suitable for members who wish to have exposure to the financial markets, while protecting themselves against adverse movements in the markets.

This is achieved by smoothing the returns over time, and guaranteeing (for resignation, retirement, death, retrenchment and disability events) the net contributions invested together with the vested bonuses.

Non-vested bonuses are also declared on top of that. These can be removed in very extreme circumstances though this has never yet occurred since the portfolio's commencement in 1986.

The strategy could be considered by investors preferring a cautious, arm's-length approach to money management; investors wishing to avoid any chance of losing money; investors who require capital security and investors who regard financial security as highly important. The strategy currently invests all contributions in the Sanlam Stable Bonus Portfolio.

Volatility Protection Strategy

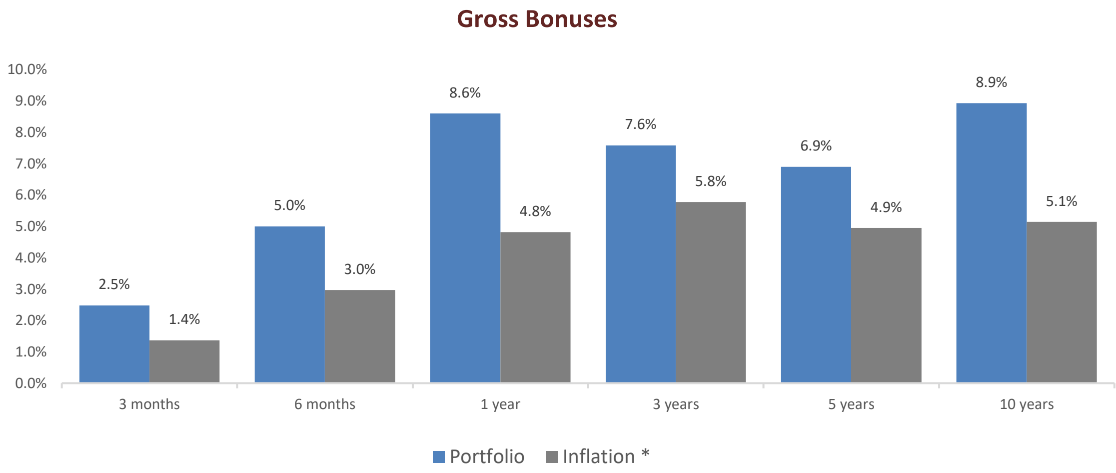
The default investment strategy is suitable for members who wish to achieve inflation-beating real returns over the medium to long term, but who are particularly concerned about protecting against significant short-term investment losses.

The strategy will most likely result in lower returns than the four Lifestage strategies over the long term as a consequence of the implicit cost of the underlying guarantees and lower effective equity exposure. Nonetheless, the trustees recognise that such a strategy is suitable for many members – particularly those members who are not financially sophisticated and who might not appreciate that a high equity exposure inevitably implies some risk of capital loss over the short-term.

The trustees review the investment strategy of the Volatility Protection Strategy continually and will make periodic changes to the underlying investments in line with the objectives of the strategy. The Volatility Protection Strategy aims to invest 75% in the Sanlam Monthly Bonus Fund and 25% in the Satrix Enhanced Balanced Tracker Fund.

Sanlam Secure Strategy

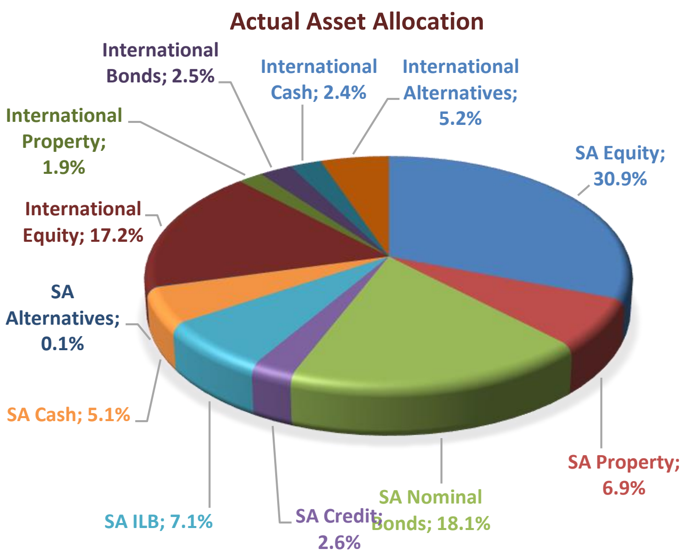
Sanlam Monthly Bonus Fund

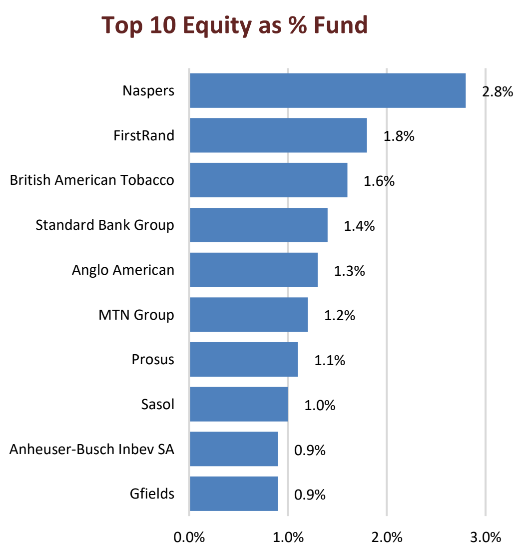


The Sanlam Monthly Bonus Fund returned 2.5% for the quarter and 8.6% for the one year ended 30 September 2023.

The portfolio consistently outperformed inflation over all periods. The returns over the last 10 years have exceeded inflation by 3.8% p.a. For this portfolio, Sanlam can never remove or reduce any of the monthly bonuses once declared.

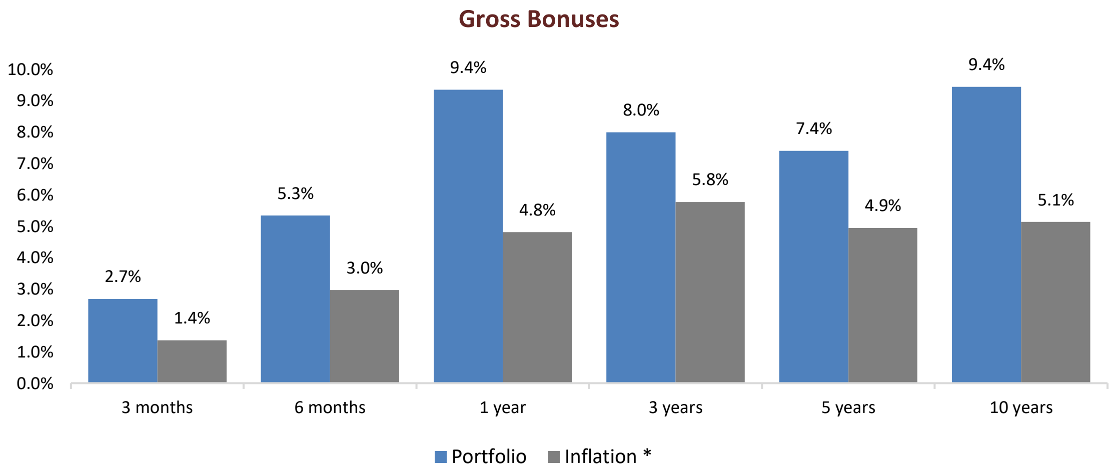
*Inflation is lagged by one month





Looking at the portfolio composition at the end of September 2023, the overweight positions were SA ILBs, International Cash, SA Equity, SA Nominal Bonds, SA Property and International Alternatives. The portfolio had a neutral position in International Bonds. The underweight positions in the portfolio are International Equity, SA Alternatives, SA Cash, SA Credit and International Property

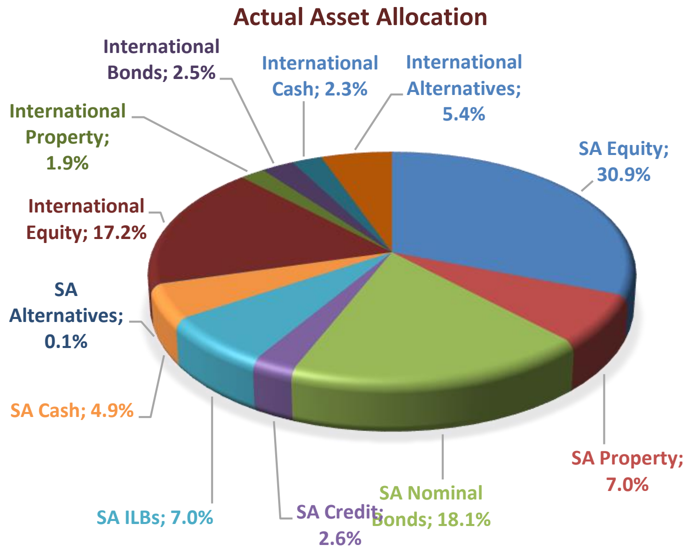
Sanlam Stable Strategy
Sanlam Stable Bonus Portfolio

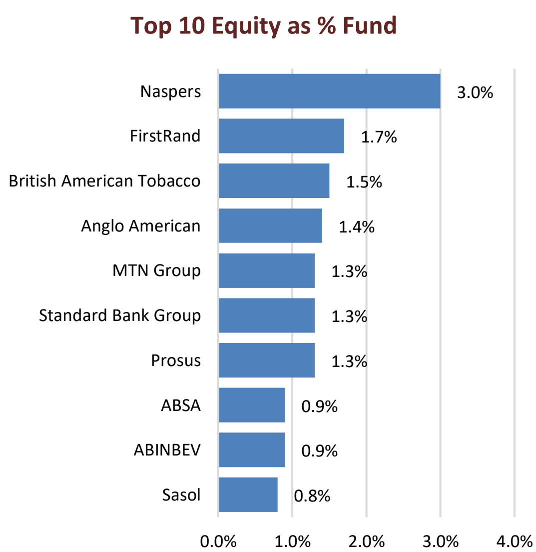


The Sanlam Stable Bonus Portfolio returned 2.7% for the quarter ended 30 September 2023 and a return of 9.4% for the year. Over the long term, the portfolio posted strong inflation beating returns.

The Sanlam Stable Strategy provides monthly bonuses, roughly half of which is vesting and half non-vesting. In an extreme market downturn Sanlam may remove some of the accumulated non-vested bonuses, although we have not done so since launching the underlying portfolio in 1986. This strategy provided a real return of 4.3% p.a. over the last 10 years, with very stable and predictable returns over the period.

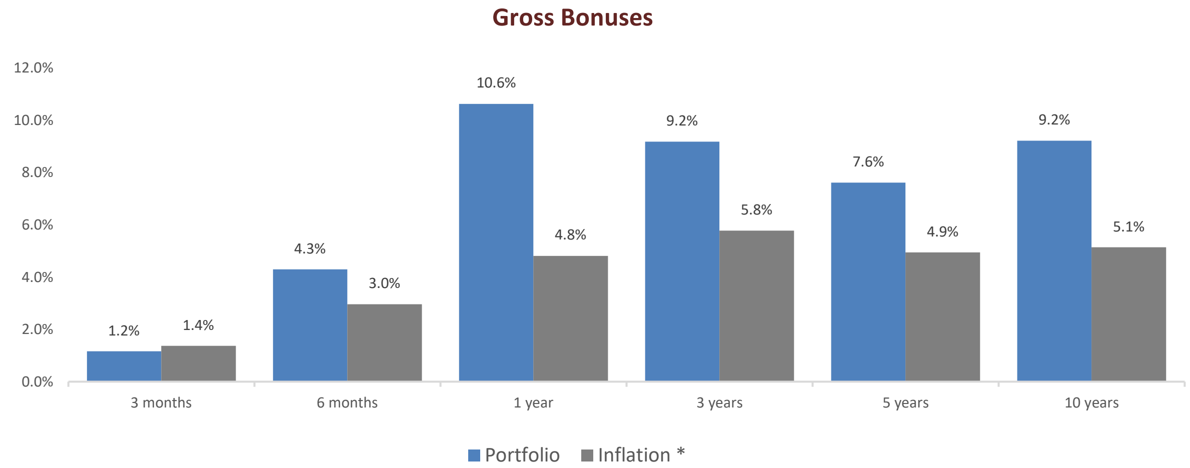
*Inflation is lagged by one month





Looking at the portfolio's composition at the end of September 2023, the overweight positions were SA ILBs, SA Alternatives, International Cash, SA Equity, SA Nominal Bonds, SA Property and International Alternatives. The portfolio had a neutral position in International Bonds and underweight in all the other asset classes.

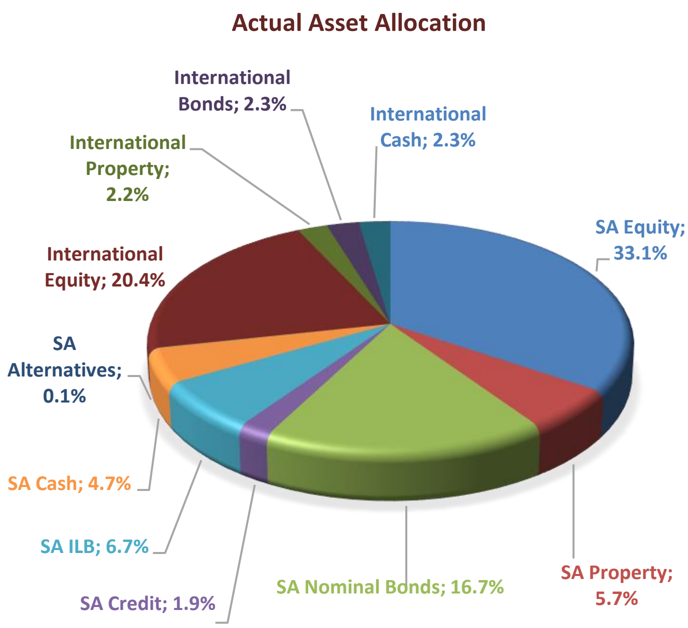
Volatility Protection Strategy

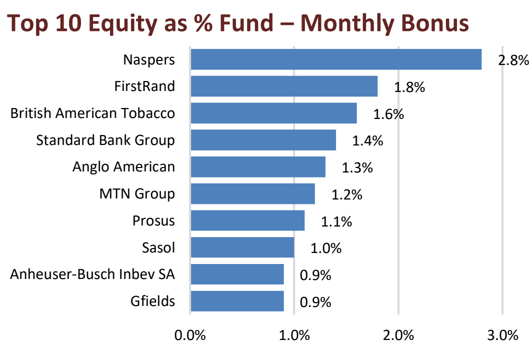


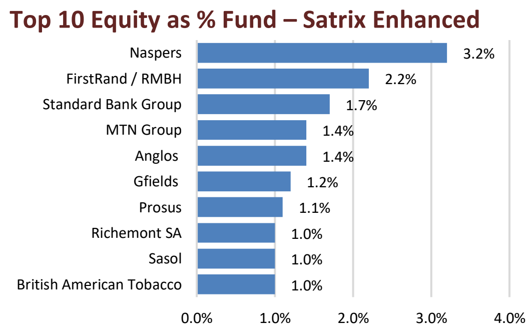
The Volatility Protection Strategy returned 1.2% for the quarter and 10.6% for the one year ended 30 September 2023.

The Volatility Protection Strategy has given a similar return to the Sanlam Secure Strategy over the last 10 years, but with a bit more volatility. This is due to the strategy since 2017 having a 25% exposure to the Satrix Enhanced Balanced Tracker fund, which is an aggressive passive portfolio. This passive component can add extra returns when markets are strong but, can lead to the strategy having occasional negative returns. It is important to note that the Volatility Protection Strategy does not provide a capital guarantee but provides returns which are far less volatile that a normal balanced fund.

*Inflation is lagged by one month







The trustees review the investment strategy of the Volatility Protection Strategy continually and will make periodic changes to the underlying investments in line with the objectives of the strategy. The Volatility Protection Strategy aims to invest 75% in the Sanlam Monthly Bonus Fund and 25% in the Satrix Enhanced Balanced Tracker Fund.

Performance summary

30 September 2023	3 Months	6 months	1 year	3 years	5 years	10 years
Sanlam Secure Strategy						
Sanlam Monthly Bonus Fund	2.5%	5.0%	8.6%	7.6%	6.9%	8.9%
CPI*	1.4%	3.0%	4.8%	5.8%	4.9%	5.1%
Sanlam Stable Strategy						
Sanlam Stable Bonus Portfolio	2.7%	5.3%	9.4%	8.0%	7.4%	9.4%
CPI*	1.4%	3.0%	4.8%	5.8%	4.9%	5.1%
Volatility Protection Strategy						
Volatility Protection Strategy	1.2%	4.3%	10.6%	9.2%	7.6%	9.2%
CPI*	1.4%	3.0%	4.8%	5.8%	4.9%	5.1%

**CPI figures are calculated to end of August 2023*
Benchmark used for Volatility Protection Strategy is 75% of Inflation and 25% of the Composite Benchmark for Satrix Enhanced Balanced Tracker Fund.

Macroeconomic commentary

Highlights

Global

- Global growth expected to decrease from 3.5% in 2022 to 3% this year and 2.9% next year
- Yield curve bear steepening triggers equity market rout
- Fed's Dot-Plot reins in 2024 rate cuts to 50 bps from 100 bps
- PBOC cuts rates and the required reserve ratio to counter CPI deflation
- Services sector PMIs slow further in August
- Oil prices surge on extended OPEC+ production cuts

Local

- SA bond yields rise as markets price in deteriorating fiscal metrics ahead of the MTBPS.
- SARB leaves rates unchanged in split 3/2 vote

Global economics

Global Equities

Global equities fell in the third quarter due to rising bond yields driven by US inflation misses and a 22% oil price surge. The yield curve steepened, signaling an expected soft landing in the coming year, aligning with the IMF's projections of slowing global growth. The IMF anticipate a slowdown from 3.5% in 2022 to 3% this year and 2.9% next year. Near-term risks are downside, with the Bloomberg GDP global tracker showing 2.4% growth in Q3. Medium-term growth is expected at 3.1%, below the historical average of 3.8%. The US 10/2-year bond spread rose, reflecting expectations of higher inflation. Fed's September dot-plot suggests a possible rate hike in November, and rate cut expectations for 2024 reduced to 50 bps from 100 bps, with rates likely on hold for a year. Tip yields increased, supported by higher break-even inflation.

In the third quarter, equities de-rated as investors adjusted to a prolonged high-interest rate environment, reigniting the inverse relationship between price-to-earnings ratios and interest rates.

This suggests that earlier optimism about rate cuts may lead to further de-ratings. Historically, the fourth quarter typically brings positive equity returns. With the Fed focusing on the duration of restrictive policy rather than rate heights, it may be nearing the end of its tightening cycle.

Higher bond market rates led to a 3.7% MSCI World Index drop, with a milder 3.1% fall in emerging markets, supported by strong Chinese data, while adjustments to reserve ratios and rate cuts improved sentiment. However, developed market earnings estimates declined, but emerging markets saw upward adjustments. Manufacturing and services face pressure, housing and consumer debt issues impact the US, while the EU faces recession risks. The IMF revised euro area growth down to 0.7% this year and 1.2% next year, and the US outlook improved to 2.1% this year and 1.5% next year. Tighter credit conditions, rising bankruptcies, and consumer struggles are factors to watch. The US may experience a growth slowdown as fiscal boosts wane in 2024.

Global Bonds

In the third quarter, bonds, typically seen as safe-havens, couldn't shield investors from a stock market decline due to rising yields driven by inflation concerns and expectations of prolonged high-interest rates. The surge in oil prices, along with worries about a broader conflict's impact, steepened the US yield curve.

Increased bond issuance and fiscal deficits in the US also weighed on bonds. Yields rose across various bond indices, causing declines in returns. Global government inflation-linked bonds fared worse, yielding -4.9%. Meanwhile, corporate bonds outperformed sovereign bonds, and emerging market bonds showed relative strength, despite currency depreciation. Countries that started tightening their rates earlier than the US may now be able to aggressively cut rates in 2024 as inflation returns to central bank target ranges. However, the strengthening US dollar, linked to expectations of higher interest rates, limits emerging markets' ability to cut rates significantly without risking currency depreciation and imported inflation. The Fed seems to have shifted focus from raising interest rates to determining the appropriate duration of restrictive policy, signaling the potential end of their rate tightening cycle.

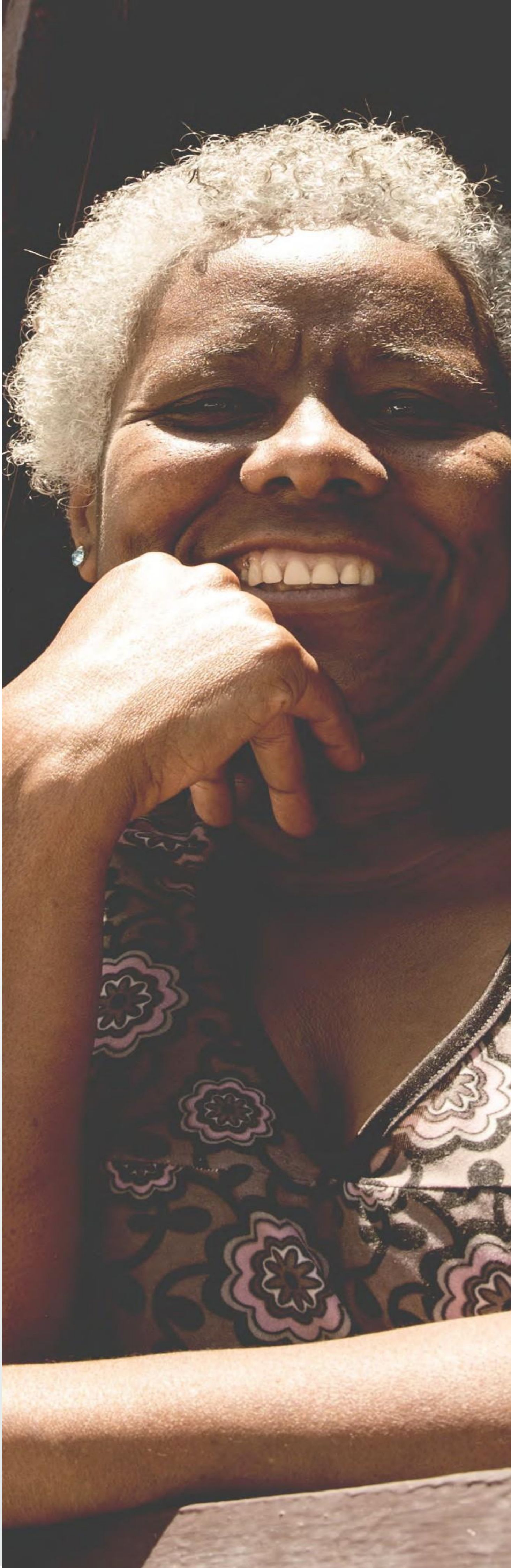
Global Listed Property

Global listed property bore the brunt of the rise in both the nominal and real curves. The FTSE EPRA Nareit Developed Markets Property Index declined by 5 5.9% in rands, the worst-performing of the broad asset classes. The sector de-rated sharply, with the price-to-book ratio declining from 1.21X to 1.14X, well below the historical mean of 1.46X. Since the to-book ratio is now back at levels seen during market drawdowns post the 2008 Global Financial Crisis, the sector is showing value. Although refinance risk is not an immediate concern, given loan-to-value ratios of 34%, debt will have to be refinanced at much higher levels with expected earnings growth revised lower to 4%. Further support for global listed property comes from the fact that REITs currently trade at a 22% discount to net asset value and offer an attractive dividend yield.

Local economics

Local Equities

South African equities could not escape the third quarter rout in global markets. They declined by 3.5% in rands and 3.2% in dollars. Domestic equities did, however, outperform their developed market counterparts but lagged emerging markets, largely due to negative returns from telecommunications (-17.2%), technology (-11.0%) and consumer discretionary stocks (-9.7%). The selloff in telecommunications was led by Telkom (-26.7%), Multichoice (-22.5%) and MTN (-18.3%), whereas technology was driven by declines in Prosus (-11.7%), and Naspers (-11.0%) due to declines in Tencent and a US technology selloff due to higher bond yields.



Expectations of higher-for-longer interest rates weighed on consumer discretionary stocks with Richemont (-25.5%), Metair (-18.7%) and Italtile (-16.8%) leading the losers. Resource counters were also lower over the quarter, declining by 4.4% on Chinese growth concerns. But it was precious metals (-17.5%) counters that bore the brunt of the higher-for-longer interest rate outlook, with Anglogold Ashanti (-23.2%), Goldfields (-20.4%) and DRD Gold (-18.4%) bringing up the rear. While healthcare stocks (-3.5%) were lower, led by Aspen (-4.6%), SA Inc counters yielded positive returns with industrials (7.8%), financials (2.2%) and consumer staples (1.8%) limiting the market selloff.

Following better-than-expected Q2 GDP growth of 1.6% YoY and 0.6% QoQ, the SARB raised its 2023 growth estimate to 0.7%, while 2024 and 2025 projections remained at 1% and 1.1%. GDP growth for H1 matched the revised estimate of 0.9%. The IMF slightly increased its 2024 growth estimate to 1.8%. However, the SARB's outlook reflects domestic challenges like softer commodity prices, persistent power cuts, infrastructure constraints, and a financially strained consumer. The start of Q3 disappointed, with mining and manufacturing production declining in July. Manufacturing's negative trend was reflected in the Absa Manufacturing PMI, and the broader S&P Global SA PMI also entered contractionary territory. While forward-looking PMIs indicate potential growth, gross fixed capital formation outperformed government and household consumption, though imports exceeded exports due to logistical issues, contributing to a trade deficit. Nevertheless, higher imports facilitated a surge in electricity generation. Ongoing electricity reforms aim to create port and rail regulators, a rail infrastructure manager, and a rolling stock leasing firm, with private sector involvement. Even coal and iron ore rail export lines may be privately operated. Transnet will transition into a holding company, with private sector participation in subsidiaries and state majority control of infrastructure.

In line with the expected uptick in economic growth over the coming year, bottom-up consensus earnings growth for the All-Share Index (excluding Prosus and Naspers) was revised upwards to 3.9% from 2.6% the previous quarter. In the second forecast year, earnings growth was revised marginally higher to 3.9%, up from 3.5% previously. Conversely, expected earnings growth for the MSCI SA Index was revised lower, from 2.3% to -1.3%. The difference in the estimates reflects the different constituents making up the respective indices and the volatility in the rand/dollar exchange rate, which has caused assumptions.

Local Bonds

Domestic bonds outperformed global counterparts despite the nation's deteriorating fiscal metrics, which led to a higher fiscal deficit and raised the All-Bond Index (ALBI) yield from 11.53% to 12.06%. The Cili Inflation-Linked Bond Index yield also increased from 4.91% to 5.04%, resulting in approximately 0.8% yield for inflation-linked bonds in rands, with rising break-even inflation rates. The five-year rate rose from 5.58% to 5.9%, while the 10-year rate increased from 6.56% to 7.15%. The significant uptick in the 10-year break-even rate raises concerns about structurally higher long-term inflation and an associated increased cost of capital that may limit growth and investment.

Cumulative revenue collection in the fiscal year's first five months fell by 0.7%, missing the 3.6% budgeted increase, while expenditure surged by 9.1%, exceeding the 1.4% budgeted increase, resulting in a significant budget deficit, far ahead of last year's corresponding period, amounting to about the full year's budgeted deficit. This compares to a previous fiscal year where the deficit was only 52% of the full year's budgeted deficit. The gross borrowing requirement is expected to surpass the R516 billion budgeted in the current fiscal year, driven by R162.3 billion in redemptions and Eskom's R78 billion debt relief. This will further delay debt stabilization due to a higher budget deficit, as the anticipated primary balance surplus over the coming years is unlikely to materialize. Pressure to maintain the Social Relief of Distress grant may lead to cost-cutting in other budget categories, and rumors of a 2% VAT rate hike in an election year could be unpopular with voters.

While headline inflation remains in line with expectations, core inflation and producer price inflation have edged higher, with further increases expected in September and October due to rising petrol prices.

The Medium-Term Budget Policy Statement in November may drive yields higher, but bonds remain attractive with yields over 12% and a real yield of 6.5% compared to 5% for inflation-linked bonds, even after considering the inflation risk premium.

Local Listed Property

The rise in bond yields weighted on the domestic listed property sector in the third quarter. The FTSE/JSE SA Listed Property Index (SAPY) declined by 1.0% in rands. Despite a lacklustre 0.9% increase in dividends per share and earnings downgrades in company guidance statements, the sector rerated slightly relative to the 10-year bond, with the property-to-bond yield ratio easing to 0.74X from 0.76X the previous quarter. With reported escalations on new leases continuing to trend lower, an oversupply of property in many subsectors and high vacancy rates, distribution growth is expected to be benign. Higher finance costs and liquidity constraints have necessitated capital retention, pointing to lower distributions over the coming year. While the sector does show value, trading at a 40% discount to net asset value, the headwinds discussed above, coupled with return expectations that lag those of the other broad asset classes, informs an underweight position in listed property. The biggest losers over the quarter included Mas Real Estate (-26.4%), Lighthouse Capital (-13.2%) and Growthpoint (-9.5%), whereas the gainers included Liberty Two Degrees (53.5%), Fortress B (20.6%) and SA Corporate Real Estate (8.5%).

Summary

Cash outperformed equities and bonds in the third quarter due to rising yields fueled by inflation risks and expectations of prolonged higher interest rates. Factors such as OPEC+ production cuts and inflation misses contributed to the surge in yields. The US yield curve suggested a soft economic landing, but short-term yield increases indicated a shallower rate-cutting cycle, aligned with the Fed's dot-plot. Equity valuations declined due to higher discount rates and earnings estimate revisions, reversing the previous positive relationship between rates and price-to-earnings ratios. The fourth quarter historically favors equity. The Fed's focus on policy duration rather than rate heights suggests it may be concluding its rate-tightening cycle. Thus, underweighting equities is recommended for early 2024, with a barbell strategy emphasizing short-term treasuries and gradually increasing duration as rate cuts become expected.

Medium Term Budget Policy Statement (MTBPS)

Curtailing government expenditure was one of the key features of the minister's speech. He stressed the need for restraint in the public service wage bill, but this has proven very difficult to implement in the past few years. The MTBPS also allocated no additional financial support, beyond what has already been announced for Eskom, to state-owned entities (SOEs).

However, rising interest payments on government debt are now crowding out spending on other priorities, particularly social relief. In the medium term, government will have to make provision for the ending of the Social Relief of Distress grant after the latest one-year extension, and there are other looming needs, including funding for Transnet (if it meets certain conditions) and the National Health system.

Finance minister Enoch Godongwana. Picture: FREDDY MAVUNDA/BUSINESS DAY

This means the South African economy needs to grow faster to reduce the unemployment rate and generate more tax revenue.

Other highlights/features:

- SA's main budget deficit forecast for 2023 has worsened, to 4.9% of GDP, compared to the 4% estimated in the February budget.
- The gross debt will rise from R4.8 trillion in the current financial year to R6 trillion in 2025/26.
- Over the next three years, debt-servicing costs as a share of revenue will increase from 20.7% in 2023/24 to 22.1% in 2026/27.
- Spending has been revised down by R21 billion for the current financial year. Further reductions of R64 billion in 2024/25 and R69 billion in 2025/26 are proposed.
- No bailout was announced for Transnet.
- No further major bailouts were announced for other state-owned enterprises (SOEs) such as Eskom, Denel or SAA.
- Additional funding of R24 billion for the 2023/2024 public sector wage increase (this is lower than an amount of R37 billion cited by Godongwana in May, as the increase will only cover key departments such as education, health and policing/defence. Other departments will need to absorb the increase, according to National Treasury)
- Fast-tracking 'growth enhancing' reforms announced by President Cyril Ramaphosa previously. (However, a new financing mechanism for large infrastructure projects is being proposed – no details were provided).

Market performance summary (in ZAR) to 30 September 2023

		3 months	6 months	1 year	3 years	5 years	10 years
Local	Equities (All Share Index)	-3.5%	-2.8%	17.7%	14.5%	9.3%	8.6%
	Equities (Capped SWIX)	-3.8%	-2.7%	11.9%	13.8%	6.4%	6.9%
	Property	-1.0%	-0.3%	12.9%	16.8%	-3.5%	1.5%
	Nominal Bonds	-0.3%	-1.9%	7.2%	7.0%	7.2%	7.2%
	Inflation Linked Bonds	0.7%	-0.1%	3.0%	8.6%	5.3%	5.2%
	Cash	2.1%	4.0%	7.5%	5.3%	5.9%	6.3%
International	Equities (MSCI ACWI)	-3.7%	8.9%	26.6%	11.3%	12.7%	14.5%
	Equities (MSCI EM)	-0.5%	8.7%	22.4%	3.9%	7.4%	9.6%
	Bonds	-3.9%	0.8%	7.2%	-3.1%	4.2%	6.0%
	Property	-6.1%	-0.2%	5.3%	4.7%	4.4%	9.1%
	Rand vs US Dollar	-0.3%	6.2%	4.8%	4.1%	5.9%	6.5%
Equity Sector	Financials	1.7%	7.1%	20.6%	21.0%	3.3%	7.0%
	Resources	-4.3%	-10.2%	-0.6%	10.0%	12.8%	6.8%
	Industrials	-6.2%	-3.0%	27.4%	12.9%	8.9%	8.3%
Size	Small Cap	1.1%	1.6%	7.0%	28.8%	9.2%	7.9%
	Medium Cap	0.9%	0.7%	7.7%	14.1%	5.8%	6.4%
	Large Cap	-4.6%	-3.7%	19.8%	14.2%	9.9%	8.8%

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