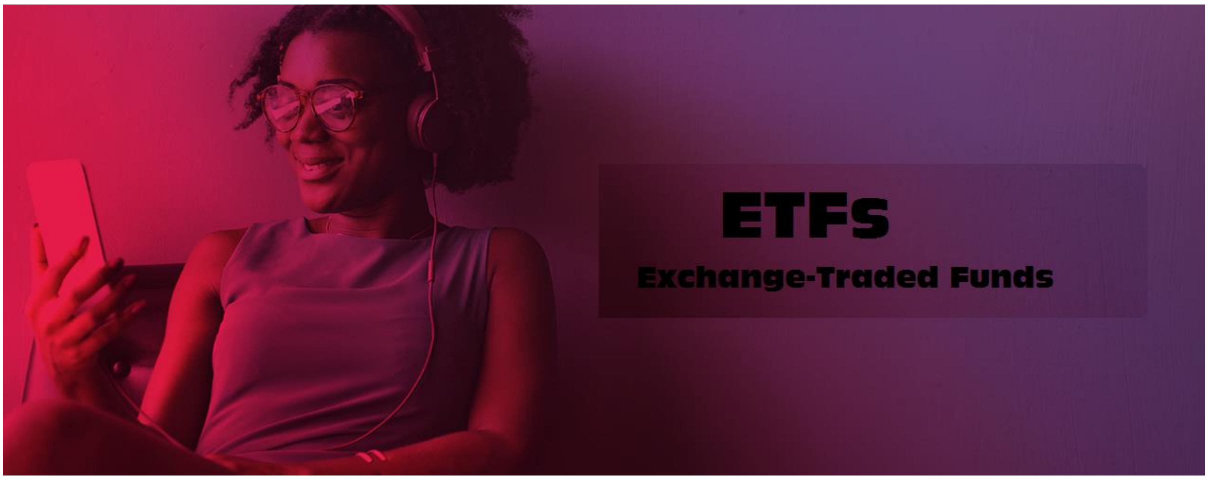


24 January 2019

The ETF Review

Welcome to this month's ETF Review, a neat update of market news affecting ETFs, as well as a set of favourite funds chosen by the Intellidex team. We collaborate with Intellidex to bring you the latest insights on ETFs – probably the niftiest way to invest!

IN THIS ISSUE:

What happened in the markets in 2018?

- SA slipped into a technical recession in Q2 but bounced back in Q3
- Trade wars between the US, Canada, the EU and China
- Commodity prices firmed
- US-China relations deteriorated

Our favourite ETFs

- Domestic equities: Satrix SA Quality ETF
- Foreign equities: Satrix MSCI World ETF and Satrix MSCI Emerging Markets
- Bonds and cash: NewFunds TRACI 3 Month (short term); Satrix ILBI ETF, Stanlib Global Bond ETF and Ashburton World Government Bond ETF (long term)
- Dividend/income funds: Stanlib SA Property ETF

Intellidex's favourite ETFs

Each month the investment gurus at Intellidex scan the market to come up with a list of their favourites.

Orin Tambo, CFA, explains:

We classify all ETFs into five broad categories:

- domestic equities
- international equities
- bonds and cash
- multi-asset
- dividend or income-focused

Various empirical studies show that the bulk of equity returns stem from diversification among broad asset classes rather than from individual stock picking. As such, our grouping is done with a diversified portfolio in mind, ensuring appropriate exposure to different asset classes. First, we group the ETFs according to the three widely recognised asset classes – equities, bonds and cash. We further split equities into geographic groupings.

What's happened in the markets?

2018 was marred by relatively high volatility and risk aversion in financial markets. Most equity markets – local and foreign – ended in the red as a result. In SA, only resources and bond funds delivered positive returns.

An equally weighted portfolio of non-commodity JSE-listed ETFs lost 3.73% during 2018, on par with Intellidex's selection of ETFs. Funds that track local assets declined 7.86% on average while those that track global markets grew 5.81%, thanks to the rand which weakened.

Local markets

South African ETFs had a rough year. Funds that track the top 40 index on the JSE fell by between 8.31% (Ashburton Top 40 ETF) and 12.84% (Absa NewFunds Swix Top 40 ETF. Even property stocks and some rand hedges, which are typically countercyclical, failed to hedge the funds against poor conditions in SA.

Contrarily, fixed income and resources funds fared relatively well. CoreShares PrefTrax came out on top with an impressive 19.24% return. Satrix Resi took second place with a 16.32% return while NewFunds S&P GIVI South Africa Resources ETF was third with a return of 10.54%.

We then add a category for equity ETFs with an income theme.

Our picks should provide an investor with a relatively diversified portfolio, even if it was made up only of ETFs. However, asset allocation is not a one-size-fits-all concept. You need to make sure that weights of different asset classes in your portfolio meet your unique risk and return objectives. Multi-asset ETFs, which are already diversified among asset classes, are analysed as a separate category.

As a rule of thumb, we like ETFs that follow a simple but watertight investment philosophy. They should also be tax smart, which means they should qualify to be in a tax-free savings account. To avoid overconcentration, a good ETF should cap its exposure to a single sector and/or a single counter. While ETF costs are still coming down as competition among local providers intensifies, we look at this metric closely and prefer ETFs with low total expense ratios (TERs).

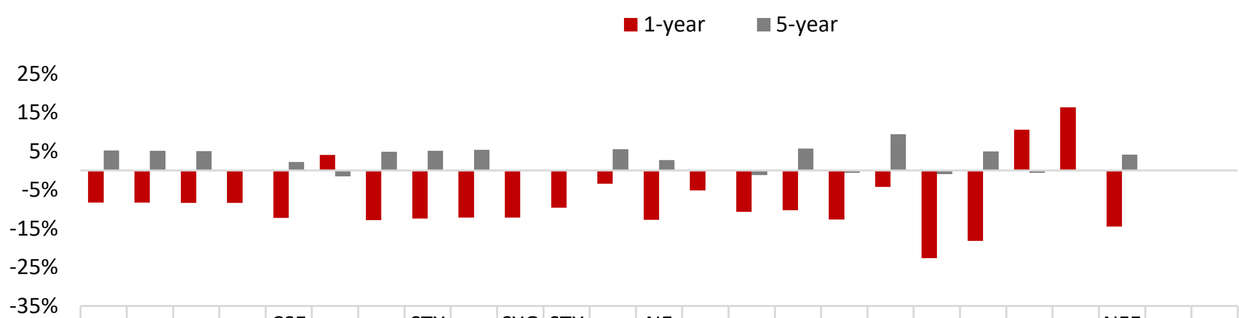
An overview of our favourite funds for each category follows

The January favourites:

Domestic equity: Satrix SA Quality ETF

Local equities have been disappointing for quite some time now. The JSE all share index gained a measly 13% in the five years to end-December 2018.

Domestic equity ETFs performance (annualised total returns in %)



	ASH T40	STX 40	STA N40	SYG T40	CSE W40	NFS H40	NFS WIX	STX SWX	STA NSX	SYG SW4	STX QUA	STX RAF	NE WF SA	CTO P50	GIVI SA	ASH MID	GIV FIN	STX FIN	GIVI ND	STXI ND	GIV RES	STX RES	NFE MOM	NFE VAL	NFE VOL
1-year	-8.	-8.	-8.	-8.	-12	3.9	-12	-12	-12	-12	-9.	-3.	-12	-5.	-10	-10	-12	-4.	-22	-18	10.	16.	-14		
5-year	5.1	5.0	4.9		2.2	-1.	4.8	5.1	5.3			5.4	2.6		-1.	5.6	-0.	9.3	-0.	4.8	-0.	-0.	4.0		

On the economic front, SA started 2018 positively, buoyed by the election of Cyril Ramaphosa as ANC president in late 2017 and later as the president of the country. Confidence was high: the FNB/BER consumer confidence index skyrocketed to 26 points (2017Q4: -8) for the first quarter of 2018, its highest level since the BER started measuring consumer confidence comprehensively in 1982. The RMB/BER business confidence index jumped 11 points in that quarter, its highest increase since 1975.

However, a confluence of adverse economic and political developments deflated confidence as the year progressed. Inflationary pressures – stemming from due to rising petrol prices, VAT increasing to 15% and the sugar tax – quashed consumer sentiment and the economy slipped into a recession in the second half of the year. The rand was as volatile as usual, influenced by local and global events.

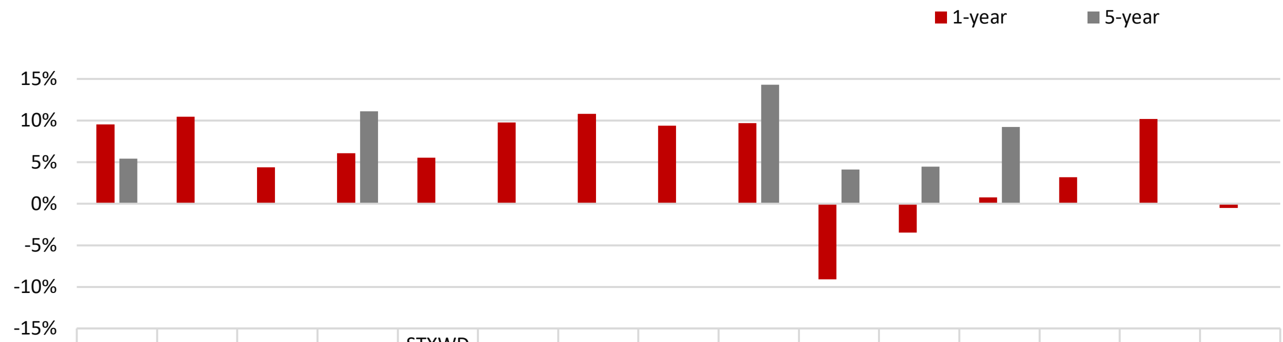
Economic data released so far show the economy remains under pressure, although there are a few positives. Mining production fell by 6% for the first 11 months of 2018. Contrarily, November retail sales increased 3.1%, indicating that black Friday sales performed better than last year, with household furniture and appliances leading the way, jumping 13.5%

Unfortunately, this trend is likely to continue this year. SA's economy is expected to remain sluggish while weak data out of Asia and Europe at the start of the year also suggest a global economic slowdown.

While there are many ways to survive depressed markets, investing in funds with quality defensive stocks could reduce losses in declining markets, while generating decent returns when the markets rise. In line with that view, we change our pick in this category from the Ashburton Equally Weighted Top 40 fund to the Satrix SA Quality ETF.

The Satrix SA Quality ETF selects constituent companies using a set of quality metrics, including return on equity, liquidity and leverage. The top 20% of all JSE-listed companies with the highest scores based on those criteria are included in the fund and weighted by market capitalisation, but capped at 10% of the fund. Empirical evidence shows that portfolios sorted on factors such as profitability and earnings quality generate high risk-adjusted returns relative to a market portfolio. However, the size of the premium varies, depending on the metrics used to calculate the quality score.

International equity ETFs performance (annualised total returns in %)



	GLPROP	SYGP	ASHGEQ	SYGWD	STXWDM	CSP500	SYG500	STX500	SYGUS	SYGUK	SYGEU	SYGJP	SYG4IR	AMIB50	STXEMG
1-year	9.53%	10.46%	4.37%	6.07%	5.54%	9.76%	10.81%	9.37%	9.70%	-9.10%	-3.46%	0.74%	3.19%	10.18%	-0.51%
5-year	5.40%			11.10%					14.32%	4.10%	4.44%	9.22%			

**Excludes fund which are less than one-year old*

Overall, we believe the performance of local assets in 2019 will be shaped by weak economic growth; a weak currency; stable inflation; an interest rate hike; no significant policy reforms bar land reform; unsustainable state owned-enterprises debt; a credit ratings downgrade; and a simple majority ANC election victory.

Local bond funds will be challenged by an upward sloping interest rate curve and a possible downgrade of SA's credit ratings. Nonetheless, we think they will outperform equities, which are likely to suffer from SA's low economic growth as well as global risks. The US-China trade talks, Brexit negotiations and the upcoming general elections in SA may fuel volatility in equity markets.

Investors can cushion their portfolios by increasing exposure to funds that are concentrated in quality and defensive stocks. Smart beta ETFs, which are focused on lower volatility and value factors may also be profitable in 2019. These are Absa NewFunds Value, Absa NewFunds Low Volatility and Satrix SA Quality.

International markets:

For funds containing international assets, the best performer was the FirstRand US Dollar Custodian Certificate ETF, which invests in US Treasuries. It rose 16.36%. At the other end of the spectrum, the Sygnia/Itrix FTSE 100 suffered a 9.1% loss on the back of the Brexit crisis.

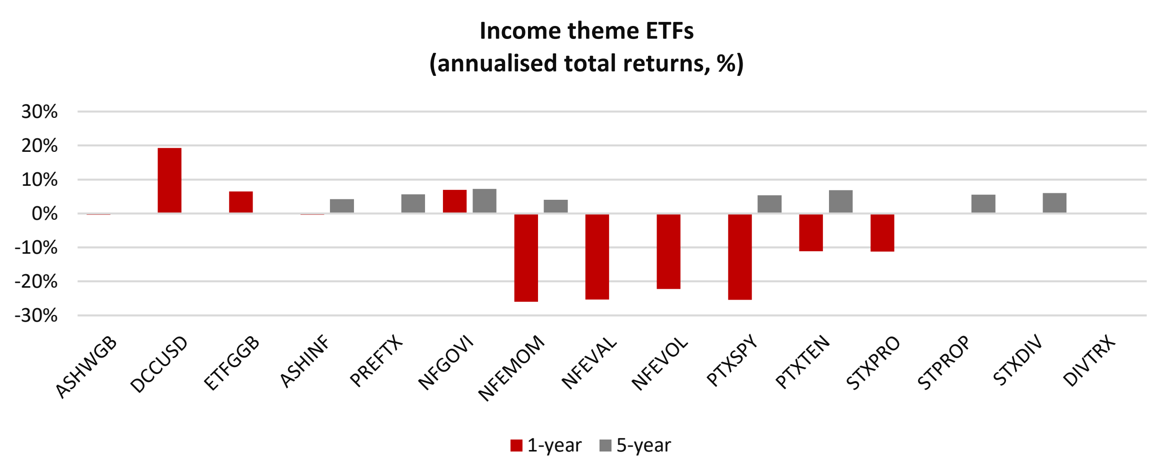
Foreign equities developed markets: Satrix MSCI World ETF

In this category we like the Satrix MSCI World Equity Feeder ETF (up 5.54% in 2018) and the Ashburton Global 1200 Equity ETF (up 4.37%). They diversify their exposure across the US, Europe, Japan, Canada and Australia. With more than half of the funds invested in US stocks, investors will still have substantial exposure to the US. Satrix MSCI World beats Ashburton Global 1200 Equity ETF on costs.

Other more focused international equity themes include property funds and technology funds. These are worth considering for tactical or other investor-specific reasons.

Foreign equities, developing markets: Satrix MSCI Emerging Markets ETF

The choice in this segment is limited to two funds: Satrix MSCI Emerging Markets and the Cloud Atlas AMI Big50. The latter was the best performer in 2018 with a return of 10.18%. Nonetheless, we still prefer the Satrix MSCI Emerging Markets ETF (down marginally by 0.51%) because of its diversification. Unlike the Cloud Atlas fund which invests in African stocks only, the Satrix fund invests in a wider range of emerging economies, including some of the fastest-growing markets such as China and India. In addition, the fund is the cheapest within its category, boasting a TER of 0.4%.



On the international scene there is a lot of noise characterised by a confluence of conflicting but largely weak economic data. Some analysts argue that this might turn out to be a good omen as governments may be compelled to pursue loose economic policies. This thinking may have birthed the equities rally in the first week of the year after the US Federal Reserve signalled a more accommodative monetary stance on the back of weaker-than-expected economic readings.

China has weighed in by promising to implement a number of stimulus measures, including tax cuts, to prop up its economy, which last year experienced one of its worst years in recent memory. If the trend of accommodative policies continues, it could be good news for equity investors both at home and globally. The US-China trade talks are so far going well and present a potential surprise to the upside. However, the Brexit scenario remains a risk. Overall, the outlook for foreign assets looks better than that for local funds.

Bond and cash funds

Bonds and cash were star performers in 2018. This is because of their low risk attributes: investors tend to gravitate to lower-risk asset classes in choppy markets. We think bonds will remain investors favourites in 2019 given the rising uncertainty in equity markets. However, expected interest rate hikes may dent the performance of some bonds.

If you are investing for a very short period, usually less than a year, then the **NewFunds TRACI 3 Month** (up 6.92% during 2018) is a natural choice because it is least sensitive to sudden adverse interest rate movements. It is like earning interest on your cash at the bank with a minimal possibility of capital loss.

For a longer investment horizon, protecting your investment against inflation is paramount. We therefore maintain our choice of the **Satrix ILBI ETF** (up 0.19%), which has the lowest expense ratio in this category.

Furthermore, nominal bonds add a unique risk-return dimension that differs from inflation-linked bonds and improves overall portfolio performance. As with equities, investors also need to diversify their bond portfolios internationally. We think investors can choose between **Stanlib Global Bond ETF** or **Ashburton World Government Bond ETF.** They track investment-grade sovereign bonds mostly issued by the US, UK, Japan and selected European countries. However, the Stanlib Global Bond ETF has the lowest TER. Both are less than a year old.

Dividend or income theme funds

If you rely on your investment income for day-to-day expenses you may want to allocate a portion of your portfolio to ETFs that have a high distribution ratio. Two funds come naturally to mind: the Satrix Dividend Plus and CoreShares S&P South Africa Dividend Aristocrats. But property funds tend to have even higher payout ratios.

We maintain our choice of the **Stanlib SA Property ETF** (down -25.40%). The Stanlib fund boasts the lowest TER in the segment. However, investors can also consider foreign property ETFs. The **Sygnia Itrix Global Property ETF** (up 10.46%) is the cheapest in this category.

Multi-asset ETFs

If you find the process of diversifying your portfolio daunting, two ETFs can do it for you. They combine equities and bonds to produce a diversified portfolio for two investor archetypes. They are the **NewFunds Mapps Protect ETF** and the **NewFunds Mapps Growth ETF**. They are designed to meet two different risk appetites: Mapps Protect is more conservative, usually suitable for older savers. Mapps Growth suits investors with a long-term horizon. They lost 4.13% and 8.95% respectively in 2018.