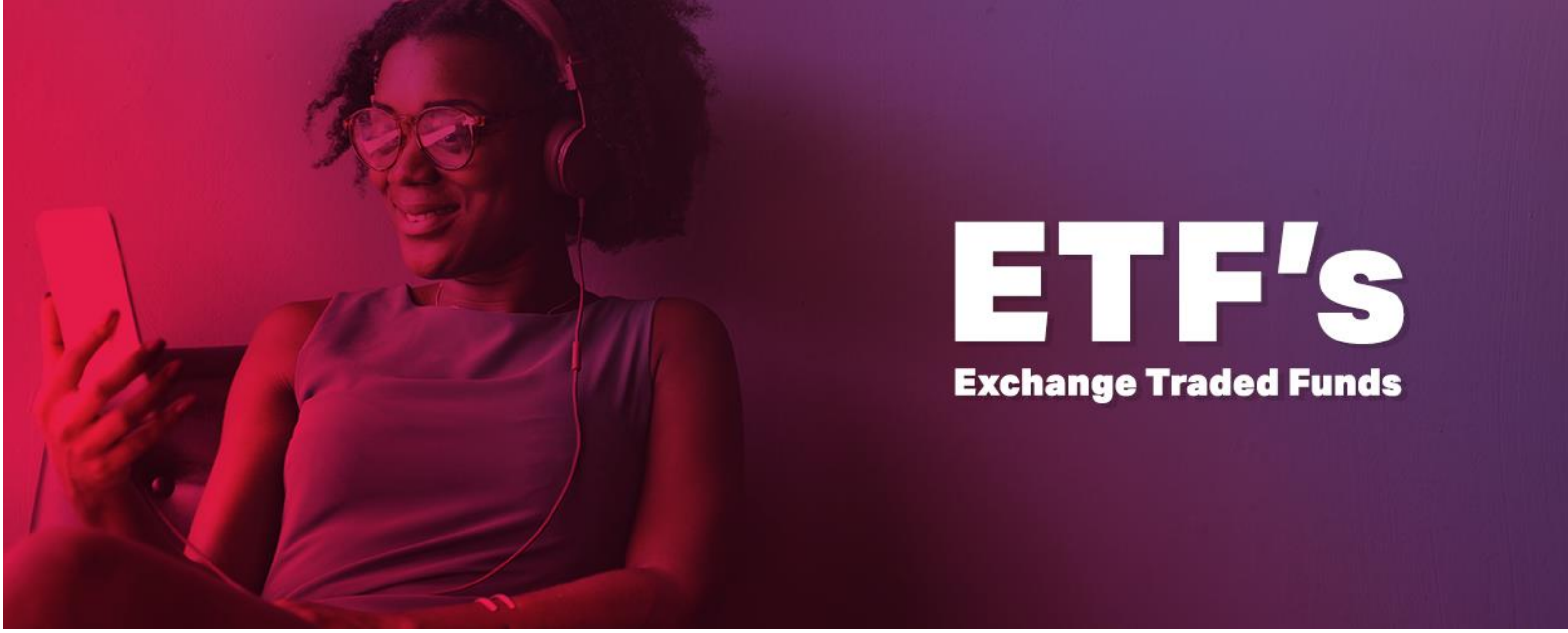


May 2018

The ETF Monthly Review

Welcome to the ETF Monthly Review, a neat update of market news affecting ETFs, as well as a set of favourite funds chosen by the Intellidex team. We're collaborating with Intellidex to bring you the latest insights on ETFs, probably the niftiest way to invest out there!

IN THIS ISSUE:

What's happened in the markets?

- Trade tensions between the US and China ease after conciliatory remarks from both countries
- StatsSA releases subdued local manufacturing and mining data

Our favourite ETFs

- Domestic equity: Satrix SA Quality ETF
- Foreign equities: Ashburton Global 1200 and Satrix MSCI Emerging Markets
- Bond & cash: NewFunds TRACI 3 Month (short term); Satrix ILBI ETF & Absa NewFunds Govi (long term)
- Dividend-focused: Satrix Property ETF

Analysis of the smart beta segment

SA is catching up with the rest of the world on smart beta ETFs. The JSE's launch of eight factor indices provides the foundation for growth of the segment. We answer some of the frequently asked questions about smart beta ETFs.

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 equity;
- international equity;
- bonds and cash;
- multi-asset; and
- dividend-focused.

We also split international equities into developed and developing markets. Not all categories are right for all investors; you want to choose asset classes that meet your unique risk and return objectives.

We believe a good ETF should be cheap. Cost differences, while appearing small on paper, can

What's happened in the markets?

April was a good month for ETF investors, particularly those invested in international funds. Local equities recouped most of the losses incurred in March as the all share index gained 5.4% month-on-month (m-o-m) and the top 40 index, the most widely tracked index by local ETFs, gained 5.76%. The resources ETFs were among the biggest gainers: Satrix Resi 10 and the S&P Givi Resi returned above 8%.

Small caps were largely flat, losing 0.33%. However, most ETFs have no exposure to small caps.

The property sector had a solid month but most ETFs in the segment remained in the red on a year-on-year basis. This sector has been under pressure largely due to the negative media reports on Resilient and its related companies. The stable is accused of manipulating share prices.

Bond ETFs were under pressure with the all bond index losing 0.66%. However, the index remains one the best performers with a return of 13.8% over the past year and a compounded return of 9.63% a year over the past 10 years.

On the international scene, the US markets got off to a shaky start as investors reacted to news that

make a huge impact on an investor's returns when compounded over time. We also 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. Generally, to avoid overconcentration, a good ETF should cap its exposure to a single sector and/or a single counter. Below we provide an overview of our favourite funds for each category.

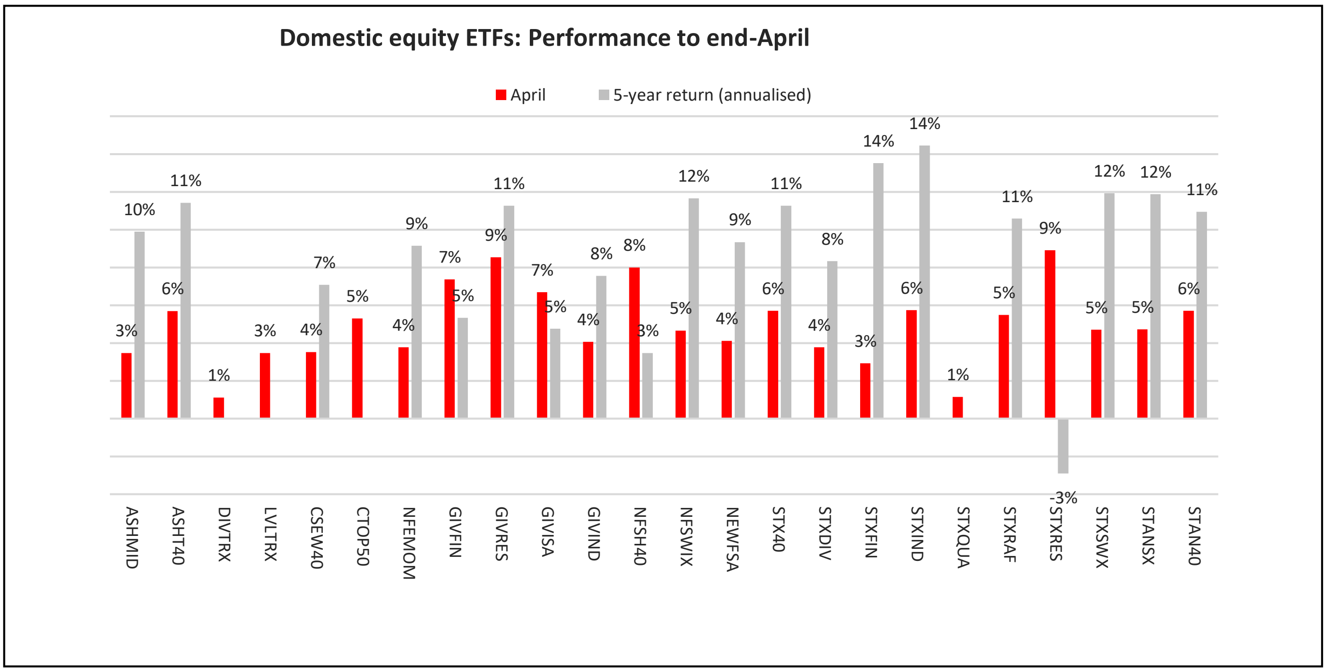
Generally, they are the same funds from month to month and we make changes to this list when new and better ETFs (in terms of the criteria explained above) are listed, fees change or there is some other fundamental change.

The May favourites:

Domestic equity: Satrix SA Quality ETF

Satrix SA Quality remains our choice for this segment despite a subdued performance over the past two months. The ETF gained a measly 1.51% during April, but that leaves its six-month return at a comfortable 19.75%.

We like this ETF because it reduces the concentration risk that has come to dominate the top 40 index as it caps the weight of each counter and sector. The fund selects constituent companies using a set of quality metrics, including return on



US President Donald Trump would impose trade tariffs on steel and aluminium imports. But subsequent conciliatory remarks by Chinese President Xi Jinping pledging to open the Chinese economy further saw a soft recovery in equity markets.

The US S&P 500, which is tracked by Sygnia/Itrix S&P 500, CoreShares S&P 500 and Satrix S&P 500, gained 0.4% m-o-m. UK stocks were among top performers with the FTSE 100 gaining 6.8% before accounting for dividends. Sygnia FTSE 100 benefited from this and returned 10.3% during April. The European markets also had a robust performance. Sygnia Itrix Eurostoxx 50 returned 9.43%, which was the second-best performance among international funds for April. Foreign ETFs were somewhat boosted by the rand weakening against major currencies.

International view:

Data from China's National Bureau of Statistics showed the country is enjoying a good start to the year. Its first quarter GDP growth remained stable at 6.8% year-on-year. Domestic consumption accounted for 78% of the economy's growth in the first quarter against 31% for investment and 9% for net exports.

The UK data releases were mixed in April. Unemployment fell to 4.2% in the three months to February, with wage growth accelerating slightly to 2.8% over the same period. UK headline and core inflation fell by more than expected (to 2.5% and 2.3% respectively). However, first-quarter GDP growth was weak at just 0.1% quarter on quarter.

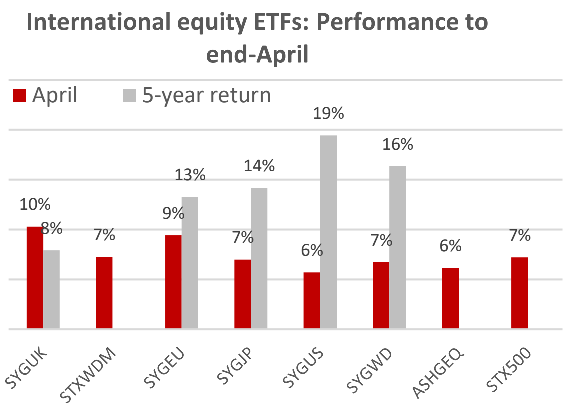
Despite some risks related to trade restrictions, geopolitical noise and expectations of tighter monetary policy, the International Monetary Fund remains bullish on world economic growth, expecting output in emerging markets to accelerate in 2019, lifted by faster growth in

equity, liquidity and the leverage of the balance sheet. 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, then capped each 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.

Foreign equities, developed markets: Ashburton Global 1200 ETF

This is another young fund, less than six months old. The ETF returned 6.15% during April, buoyed by strong performances from the UK and Europe.

Most diversified global funds tend to be overweight in US equities, reflecting their dominance in global equities markets in terms of capitalisation. However, we maintain our exposure to this fund because in addition to the US, it gives exposure to other developed markets.



Its universe is: S&P 500 (US); S&P Europe 350; S&P TOPIX 150 (Japan); S&P/TSX 60 (Canada); S&P/ASX All Australian 50; S&P Asia 50; and S&P Latin America 40.

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. Our choice for Satrix MSCI Emerging Markets is motivated by its diversification. The fund provides exposure to high-growth economies such as China and India, which are not included in any of the developed market funds, thus offering further diversification. The

India, Latin America as well as sub-Saharan Africa. This outlook bodes well for most international ETFs. However, investors will need to factor in the rand outlook as that tends to have a bigger say in the performance of foreign ETFs.

The local view:

Locally, the focus was on data released by StatSA and the Bureau of Economic Research. The Absa purchasing managers index (PMI) – which is generally regarded as an indicator of the economic health of the manufacturing sector – disappointed in March by falling to 46.9 points from 50.8 in February. This suggest that the manufacturing sector may have come under renewed pressure.

Data released by Stats SA during the second week of April seem to support the PMI readings. Seasonally adjusted manufacturing output declined by 2.4% in February. Mining production for February grew marginally by 0.9% m-o-m, from 1% in January. Markets were positively surprised by the March consumer price index figure, which slowed to 3.8% from 0.4% in February.

Satrix MSCI Emerging Markets ETF tracks the MSCI Emerging Markets Investable Markets index, which captures companies across 23 countries.

Bond and cash funds

Bonds and cash are good additions to portfolios not only because of their diversification qualities but also for their ability to enhance returns.

If you are investing for a very short period, usually less than a year, then the NewFunds TRACI 3 Month (NFTRCI) is a natural choice because it is least sensitive to sudden adverse interest rate movements. It is similar to earning interest on your cash at the bank with a minimal possibility of capital loss. Its return was 0.6% in April.

However, for a longer investment horizon, protecting your investment against inflation is paramount. We therefore maintain our choice of the Satrix ILBI ETF. Less than a year old, it promises to have the lowest expense ratio of 0.22% compared with peers. It lost 2.72% during April in line with other bond ETFs.

SA's Smart beta segment

Smart beta, also called alternative beta, is the fastest-growing category in the investment industry. A study by the Financial Times (Mooney Attracta, 2017)[1] found that that assets under management (AUM) in smart beta funds grew 30% a year between 2012 and 2017. While the segment is still at an early stage locally, we expect it to gain traction in line with global trends. Now, only Absa's NewFunds, CoreShares and Satrix have smart beta ETF offerings. However, with the launch of eight new smart beta indices by the JSE in August last year we expect to see more fund managers launching ETF funds to track these indices.

What is smart beta? Smart beta is an umbrella term for rules-based investment strategies that do not use the conventional market capitalisation weights – size of the company – in building portfolios. Smart beta rank/selects investments based on investment characteristics or factors believed to drive equity returns.

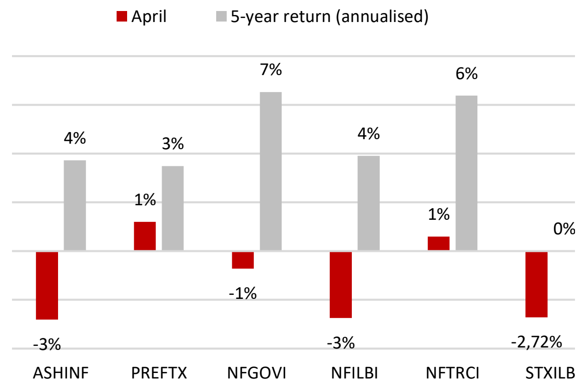
Which factors are profitable? According to estimates developed by Harvey, Liu and Zhu (2016)[2], there are at least 300 published factors. Given such a zoo of factors it's difficult to believe that every one of them will deliver reliable returns in the future. Our rule of thumb is that investors should **focus on those factors supported by a body of empirical evidence across different geographies and time periods**. These include: value (cheap stocks outperform), size (small stocks beat big), low-risk (lower risk, less volatile stocks outperform, though the evidence on this is mixed), momentum (winners keep winning and losers keep losing), quality, income (the notion that higher income stocks will return more).

What are the benefits of adding smart beta to one's portfolio? Smart beta funds serve three main purposes in one's portfolio. They enhance returns, improve diversification and reduce risk. The main selling point of smart beta is that they give investors access to active investment strategies at a fraction of the cost of active portfolios. This allows investors to enhance returns without incurring the exorbitant costs associated with actively managed portfolios.

How best can one use smart beta? Several research papers have shown that smart beta may outperform capped indices in the long run, but they also tend to be cyclical or underperform in the short term. To reduce that cyclicality, investors should combine several single-factor ETFs and create a diversified multi-factor portfolio. Alternatively, one can invest in ready-to-use multifactor smart beta ETFs. Currently the SA ETF market doesn't have such offerings. However, with the launch of the two multi-factor indices by the JSE it's a matter of time before we see multi-factor ETFs.

1 Mooney Attracta. 2017. 2,000% rise in new money allocated to smart-beta funds. *Financial Times*.

2 https://www.ft.com/content/5c5960d0-3668-11e7-99bd-13beb0903fa3 [2017, November 20]

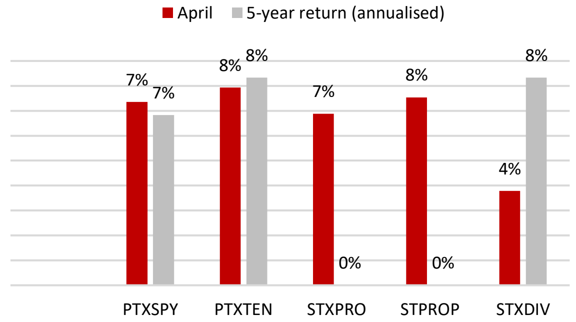


In the past we were preoccupied by inflation when the economy was under the reigns of Jacob Zuma. Now, we think the government's credit outlook will continue to improve, and thus exposure to government interest rate bonds is sensible. The only fund in this category is the Absa NewFunds Govi. In addition, it improves diversification of the overall fund because its return properties differ from those of inflation-linked bonds.

Dividend-focused funds

Naturally, Satrix Dividend Plus and CoreShares S&P South Africa Dividend Aristocrats come to mind here, but similarly, property funds are high dividend payers. There are two investable property indices available: SA listed property and the capped property index. We maintain our choice of the capped fund Satrix Property ETF. The fund has an expected TER of 0.30%, which makes it the cheapest in the segment. The property sector has fallen on hard times lately but we believe that is transitory. The Satrix Propaerty fund made a marginal return of 6.88% in March.

Dividend focused ETFs: Performance to end-April



Multi-asset ETFs

If you find the process of diversifying your portfolio daunting, two ETFs 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: Protect is more conservative, suitable for older savers nearing retirement. Growth suits younger savers with a long-term horizon.

Mapps Growth gained 3.07% during April while Protect gained 0.78%.

Multi-asset ETFs: Performance to end-April