

Mid-Year Review

2018

The year started on a euphoric note following the election of President Ramaphosa as the new leader of the ANC in December 2017. The rand firmed, bonds and SA-focused shares rallied. Coming on the heels of the strong performance of SA Equities in 2017 (+16.9%), investors anticipated 2018 with renewed optimism.

The strong 2017 equity returns flew in the face of a largely bearish back drop. During the year, Pravin Gordon was dismissed as Finance Minister, South Africa's foreign currency rating was down-rated to sub-investment grade or "junk" by Standard & Poor's (S&P's), and the

Medium-Term Budget Policy Statement in October predicted weak growth and a higher-than-expected budget deficit. South Africa also experienced negative fallout from the ongoing state capture saga and the implosion of Steinhoff. Internationally, the seeming impasse in Brexit negotiations and the nuclear standoff between the United States and North Korea dominated headlines.

Had investors reacted to this "noise", and disinvested from the market during the year, they would have missed the rally in the second half of the year. It was a timely reminder that wealth is more reliably generated by time in the market than by trying to time the market.

Initially, positive investor sentiment carried over into 2018. However, some of the optimism was cut short by rising inflation expectations and fears that the US Federal Reserve (Fed) would hike rates more aggressively than initially thought.

END OF 'EASY MONEY'

The resultant correction in February wiped out January gains (and more) as investors started to factor in the end of the Fed's "easy money" policy, which had supported asset prices since the 2008 Global Financial Crisis. The correction saw stock markets from the US, Europe, Japan and South Africa all selling off between 8-10% over a matter of days.

'At times the rand tends to get knocked around like a punching bag'



This also marked the return of heightened volatility in global equity markets. The sell-off was short lived and by the end of February the S&P 500 had recovered its losses. This pattern of volatility – short-term sell-offs followed by full recoveries – became the norm over the first six months of 2018. Most global equity markets ended the half-year approximately where they started in January.

LEADERSHIP CHANGE

Locally, the change in leadership helped to stave off a ratings downgrade by Moody's. The agency had placed the government's rand-denominated debt on review in November 2017 following the deteriorating fiscal projections in the Medium-Term Budget Policy Statement. The corrective action promised by President Ramaphosa prevented our downgrade to sub-investment grade or "junk" status. This would have seen SA Government Bonds excluded from the Citi World Government Bond Index,

and forced many offshore investors (WGBI trackers and investors mandated to hold only investment-grade debt) to sell. Most likely, the rand would have depreciated significantly on the back of this, stoking inflation and interest rate fears.

US-CHINA TRADE WAR

This rating reprieve provided only a brief respite, however. Internationally, the distant threat of a nuclear war was overtaken by President Trump's provocation of a trade war with China. The US introduced duties on imports from China, Europe and other trading partners, who retaliated with duties of their own. This stand-off has since escalated to the extent that global trade growth has slowed, adding to the volatility in financial markets.

The prospect of weaker economic growth invariably feeds negative sentiment towards emerging market economies that are over-reliant on commodity exports, such as South Africa. Foreign investors tend to withdraw their money from these markets at such times, instead seeking shelter in hard currencies and developed markets. This is the so-called "risk-off" environment.

FED HIKES RATES

This "risk off" environment was exacerbated by the US Fed hiking rates at the end of March. This saw the US dollar recover against the world's major currencies, after depreciation for 18 months. Dollar strength inevitably leads to commodity price weakness, creating a negative feedback loop for emerging markets. The second quarter of 2018 saw the rand depreciate more than 16% alongside other emerging market currencies.

Although this type of currency weakness is a cyclical phenomenon, it is exacerbated by structural factors such as large current account and budget deficits, poor governance, policy uncertainty and investor-unfriendly rhetoric. At times like these, the rand tends to get knocked around like a punching bag.

With so much noise and short-term volatility in our markets, it is easy for investors to get unnerved and let such noise dictate their decision-making. But, especially at times like these, it is important that retirement savers focus on their long-term outcome, and not on the short-term swings and roundabouts. It is not possible to navigate these as they are random, but investors can control the former, by sticking to a sensible investment plan that is appropriate for their time horizon. More specifically, investors can control the fees they pay and how much of their portfolio is allocated to growth and defensive assets.

Historically, growth assets (essentially the stock market) have delivered the highest inflation-

beating returns and are, therefore, the most reliable generators of real wealth growth.

INFLATION-BEATING GROWTH

Retirement investors require this kind of inflation-beating growth to secure a comfortable retirement; saving alone will not suffice (unless you are prepared to save upward of half your income every month instead of the recommended 15%).

At 10X, we don't know what the market will do in the short term, but we do believe in mean reversion over the long term. Each asset class has established an average long-term return and, historically, periods of below-average return have been followed by periods of above-average return.

Figure 1: **Growth asset class returns: Actual versus long-term average real return (%pa)**



i Source: 10X Investments

Fig 1 above shows the real (after-inflation) annualised return of the 10X growth asset classes over different periods (1, 3, 5, 7 and 10 years). **The red lines represent the long-term mean return for each asset class.** Short term returns (up to 5 years) can deviate markedly from the mean but over longer periods (10 years or more) we would expect returns to tend back towards the historical average.

Over the 12 months to 30 June 2018 **SA EQUITY** delivered returns near the long run mean, a welcome shift in performance in light of the negative real return over 3 years.

This low-return period has caused the 10-year real returns to also lag the long-run mean. However, to put that into context, 30 June 2008 (10 years ago) was close to the top of the market before the financial crisis hit (i.e. measured off an elevated market level). The returns over the past seven years (which excludes high and low points before and after the financial crises) show a normalised return pattern.

SA PROPERTY was significantly affected by the price correction in the Resilient group of companies, which comprised 35% of the

SA listed property market. This reflects in the asset class's strongly negative real returns over the past 12 months. Local property shares have been the star performer in recent years, to the extent that the sector's long-term real return was far above the historical average. Even without the Resilient episode, a correction was thus inevitable at some point. Despite the recent sell off, SA Property's long-term returns are still far above the mean, which suggests that returns in this asset class could disappoint for a little while yet.

INTERNATIONAL EQUITY has benefited from both a strong run-up in US equities (which comprise approximately 40% of the exposure) as well as the depreciation of the rand over the last 7 years.

Figure 2: **Defensive asset class returns: Actual versus long-term average real return (%pa)**



i Source: 10X Investments

SA BONDS have delivered returns below their long run average in recent years. Despite falling inflation the market has been pricing in risks associated to credit rating concerns.

SA CASH has performed better than expected as interest rates have held up despite falling inflation. The Reserve Bank appears reluctant to lower interest rates at this stage, possibly because of worries about the currency, and debt accumulation

impact. Once inflation expectations increase on the back of recent rand weakness, the excess return is likely to decrease.

Whilst **INTERNATIONAL CASH** yields are starting to increase, the main driver for local investors is still the Rand/US dollar level. As this is still lower than three years ago, it serves as a drag on the rand return. This could fully unwind if the rand continues to lose ground, as it has in recent months.

10X Asset Class Performance

Despite local pessimism, growth assets delivered strong returns in 2017, most of which accrued in the second half. With the return of volatility this year we have given back some of these gains.

Figure 3: **10X benchmark asset class returns (before fees) to 30 June 2018**

	2018 YTD	2017	2016	2015	1 YEARS	3 YEARS	5 YEARS	7 YEARS	10 YEARS
SA Equity	-3.0%	16.9%	2.9%	3.0%	11.5%	4.3%	9.9%	12.0%	10.3%
SA Property	-21.4%	17.2%	10.2%	8.0%	-9.9%	0.9%	6.7%	11.7%	16.0%
SA Bonds	1.3%	6.5%	14.7%	0.4%	5.6%	5.6%	6.3%	7.5%	7.7%
SA Cash	3.4%	7.1%	7.0%	6.1%	7.0%	6.9%	6.4%	6.1%	6.6%
International Equity*	9.7%	13.2%	-3.3%	28.5%	16.1%	12.4%	16.3%	18.3%	11.2%
International Cash	10.7%	-9.6%	-11.5%	33.7%	4.7%	4.0%	6.7%	10.6%	5.8%
SA Inflation (CPI)	4.5%	5.3%	6.7%	4.7%	4.6%	5.3%	5.5%	5.5%	5.4%

*Between 1 Dec 2011 and 28 Feb 2013, this benchmark contained 20% International Cash and was called the International Composite benchmark.

SA Equity

The SA Equity class has delivered negative nominal returns in the year to June 30 (-3%), albeit on the back of a strong 2017 (+16.9%). As we explained previously, this was largely due to the “risk-off” environment evident since the second quarter. Nevertheless, the local fallout was far less pronounced than in other emerging markets due to the strong rand hedge elements in our market (dual-listed and resources stocks).

SA Bonds

The declining inflationary environment, Ramaphoria and averting the Moody’s downgrade of local currency debt were supportive of SA’s fixed income markets in Quarter 1. However, inflation-linked bonds make up 50% of the 10X SA Bond asset class and, in the face of falling inflation, have posted flat returns for the period. In Q2, the emerging market “risk-off” environment impacted negatively on nominal bonds, causing the benchmark 10-year yield to rise from 7.9% to 9.2% over the second quarter.

SA Property

As discussed above, this asset class came under pressure from concerns around the Resilient Group. This group of companies constituted 35% of the Index. By comparison, the long-term industry stalwarts, Growthpoint and Redefine, held up well during the selloff over January and February. Given the yield sensitive nature of the sector, property shares weakened in Q2 on the sell-off in SA Government Bonds.

SA Cash

In the face of steady rates despite declining inflation, SA Cash generated a healthy return for the period.

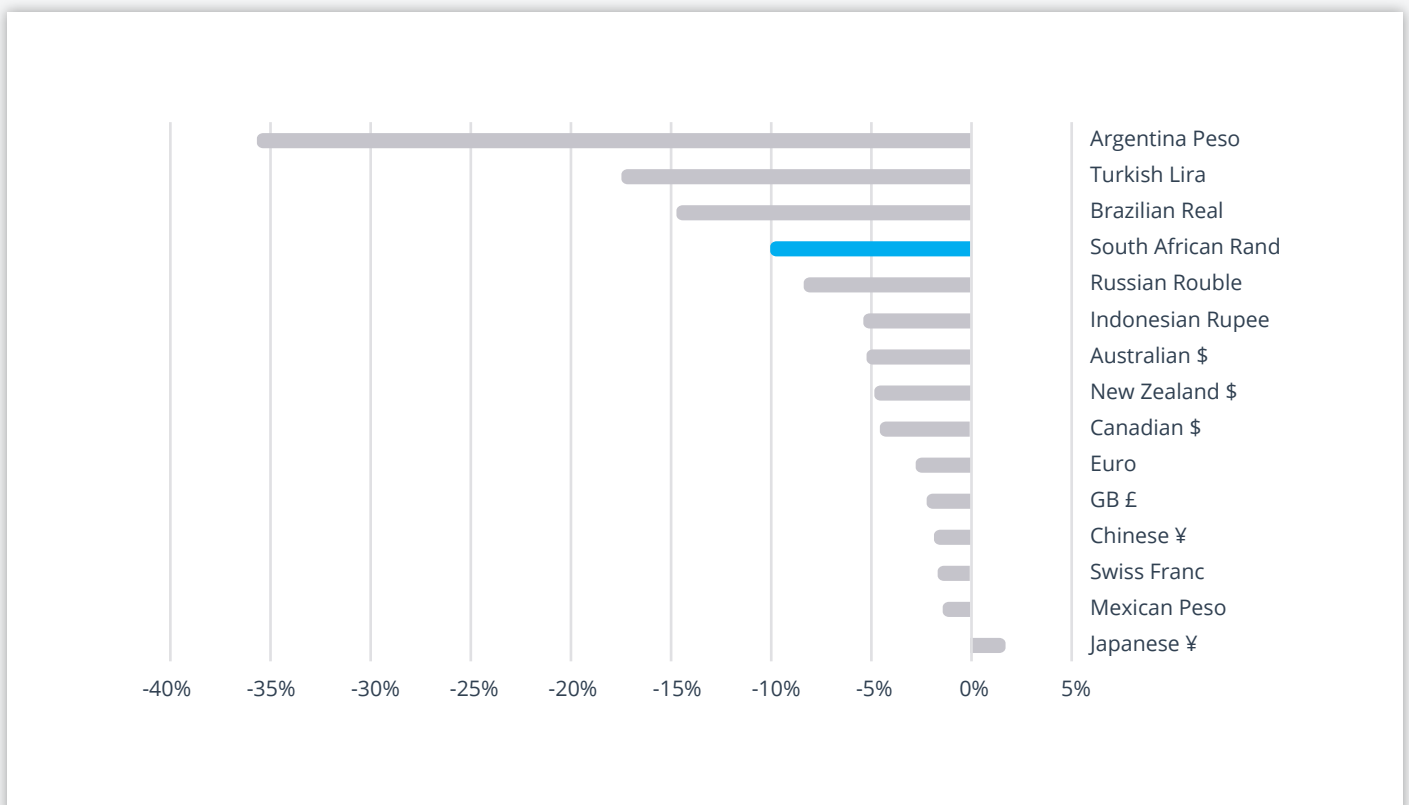
International Equity

Global equities were much more volatile than in recent years, with dollar returns ending marginally positive at 1%. For local investors, the 9.7% year-to-date return is almost entirely due to rand depreciation.

International Cash

US interest rates have begun to normalise with the Federal Reserve increasing rates to 1.75% by the end of June. Investors are starting to enjoy some yield on international cash, but for locals the main driver of this asset class is still the USD/ZAR exchange rate. Our currency sold off heavily in May and June on the back of the global “risk off” environment, boosting the rand return on this asset class.

Figure 4: **Currencies vs USD Year-to-date 30 June 2018**



i Source: Reuters

10X Portfolio Performance

Each 10X portfolio blends the returns of the various asset classes in proportion to its asset allocation.

With local growth assets SA Property and SA Equity coming under pressure through the first half of the year, it has been the defensive portfolios that have thus far fared better in 2018. The 10X Medium Equity portfolio has been the weakest performer as this has highest allocation to SA Property, the asset class most under pressure year to date.

The extended period of modest returns is most evident in the 3-year numbers, with all portfolios returning between 5.9% and 6.9% pa. Although well below the long-term expectations, these returns have at least kept pace with inflation.

The 10-year numbers, whilst below long-term expectations (10X High Equity returning CPI+5.5%), include the Great Financial Crisis of 2008 and start at the peak of the market in 2008. The 7-year numbers reflect more normalised returns of CPI+6.7% for the 10X High Equity portfolio.

Figure 5: **10X Life-stage portfolios returns (before fees) to 30 June 2018**

	2018 YTD	1 YEARS	3 YEARS	5 YEARS	7 YEARS	10 YEARS
10X High Equity	-0.1%	10.3%	6.2%	10.3%	12.2%	10.9%
10X 60% Equity	-0.4%	9.1%	6.0%	9.8%	11.7%	10.6%
10X Medium Equity	-0.8%	8.0%	5.9%	9.4%	11.2%	10.2%
10X 40% Equity	0.7%	8.2%	6.4%	9.1%	10.6%	9.9%
10X Low Equity	1.5%	7.6%	6.5%	8.3%	9.2%	9.0%
10X Defensive	2.4%	6.9%	6.9%	7.6%	8.2%	8.4%
SA Inflation (CPI)	4.5%	4.6%	5.3%	5.5%	5.5%	5.4%

i Source: 10X Investments

10X Performance relative to competitors

How do our portfolios measure up against the competition in the South African retirement fund industry? To find out, we regularly compare the performance of the 10X High Equity Fund (held by more than 90% of 10X fund members) against the median return delivered by the large retirement fund managers, as published monthly in the Alexander Forbes Global Manager Watch Survey (GMW).

10X's goal is to beat the median fund manager's return over time, net of fees. To quantify the impact of our lower fees, we reduce the average fund manager return by 1% pa. This is a reasonable (and conservative) estimate, especially for small and medium size funds, many of which pay total fees well above 2% pa (versus the average 10X fee of well less than 1% pa).

The table below shows that the 10X High Equity Fund has beaten the median manager by more than 1.6% since inception after adjusting for our lower fees. The last 12 months has seen the High Equity portfolio deliver a pleasing 1.7% outperformance. This is a significant enhancement. The power of compounding seemingly small return differences over an average working life of 40 years can produce up to 60% more money at retirement, and up to 150% more by the end of an average lifetime (i.e. factoring in the post-retirement investment period).

Figure 6: **Return comparison: 10X High Equity versus median manager**

RETURNS TO 30 JUNE 2018	10X HIGH EQUITY (BEFORE FEES)	GLOBAL MANAGER WATCH MEDIAN	GLOBAL MANAGER WATCH MEDIAN (AFTER FEES)	10X EXCESS RETURN
1 Year (% pa)	10.2%	9.6%	8.5%	1.7%
3 Year (% pa)	6.2%	6.7%	5.6%	0.6%
5 Year (% pa)	10.3%	10.1%	9.0%	1.3%
7 Year (% pa)	12.2%	11.8%	10.7%	1.5%
10 Year (% pa)	10.9%	10.9%	9.8%	1.1%
Inception Jan 2008 (% pa)	10.7%	10.2%	9.1%	1.6%

i Source: Alexander Forbes Global Manager Watch, 10X Investments

10X Portfolio Tracking

10X's indexed investment strategy aims to deliver the investment type (asset class) performance at low cost. We monitor our investment performance by comparing the 10X portfolio return to the benchmark return (i.e. the asset class return multiplied by its weighting in the portfolio over the period). This difference in performance is called the tracking error. It is our goal to keep the tracking error – positive or negative – as low as possible.

The tracking error has two main sources. Firstly, it relates to trading costs (brokerage), securities tax when buying shares (0.25%), the cost of investing internationally as well as in money markets and ancillary trading-related expenses. Secondly, it reflects the time delay in receiving funds (contributions and dividends) and re-investing these funds. This is called the cash drag and represents the opportunity cost of not being fully invested in an asset class (e.g. equity markets). Cash drag can be positive (i.e. improve the return) or negative (reduce the return).

In the graph below, we have broken the tracking error down into trading costs (grey columns) and cash drag (blue columns). The green line shows the net tracking error (trading costs and cash drag combined).

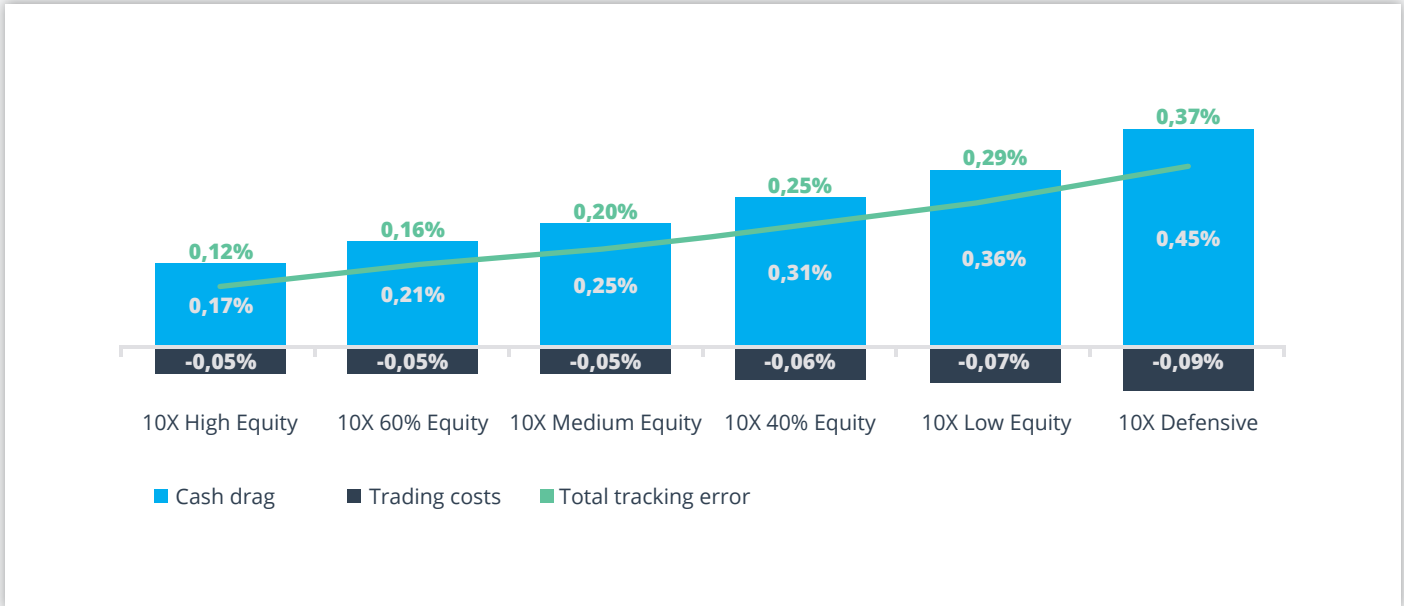
Over the last 6 months cash drag was positive across all portfolios ranging from 0.17% for 10X High Equity to 0.45% for 10X Defensive.

The 10X funds' trading costs for the period ranged from 0.09% for Defensive to 0.05% for High Equity. Our trading costs are typically much lower than that of actively managed funds as indexing is largely a buy and hold strategy. As portfolios become larger, the scale tends to reduce trading

costs even more. The net tracking error ranged between 0.12% for 10X High Equity and +0.37% for 10X Defensive.

The returns published by 10X in this review (as well as on its fact sheet and in your benefit statement) are net of this tracking error.

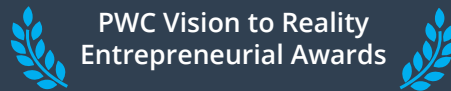
Figure 7: 10X Life-stage trading expenses and tracking error (6 months to June 30)



Source: 10X Investments



PROUD WINNER 2016 Awards



2015 Awards



Cape Town Office

Suite 105, Foyer A, Sovereign Quay
 34 Somerset Road
 Green Point, WC
 8005
 South Africa
 +27 (0)21 412 1010

Johannesburg Office

Block D, Upper Grayston Office Park
 152 Ann Crescent
 Sandton, GT
 2031
 South Africa
 +27 (0)11 685 1300