ALLANGRAY

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Two decades for the Allan Gray Balanced Fund

The Allan Gray Balanced Fund celebrated its 20-year anniversary on 1 October 2019. The local industry looks vastly different today to how it looked two decades ago, but investors continue to need well-diversified funds that can meet their needs through different market cycles. Duncan Artus looks at the Fund's performance and positioning over time.

The first unit trusts in South Africa were launched in the mid-sixties. By the end of 1999, around the time we launched the Allan Gray Balanced Fund, there were 271 unit trusts on offer, with a combined market capitalisation of R108 billion, according to the South African Journal of Business (2001). The local industry has experienced incredible growth since then, with over 1600 unit trusts to choose from, and the country now ranks 20th in the world (out of 47 countries) in terms of the dollar value of assets under management, according to the Investment Company Institute. See **Table 1** below.

Table 1: Global unit trusts assets under management

Rank	Country	Q2 2019 AUM ($m)
1	United States	26 190 043
2	Luxembourg	5 020 160
3	Ireland	3 084 831
4	Germany	2 526 769
5	France	2 163 766
6	Australia	2 105 990
7	Brazil	2 030 665
8	Japan	1 936 167
9	United Kingdom	1 833 719
10	China	1 803 728
11	Canada	1 762 775
12	Netherlands	923 459
13	Switzerland	625 118
14	Republic of Korea	537 761
15	Sweden	431 491
16	Spain	336 777
17	India	323 776
18	Italy	277 885
19	Austria	209 810
20	South Africa	200 023

Source: Investment Company Institute (ICI)

Looking back at the Allan Gray Unit Trust Annual Report from 1999, then chairman of the unit trust business, Jack Mitchell, wrote: "Rising markets inevitably herald the prospect of increased risk. Mindful of this fact, we have broadened our range of unit trust services to include a 'balanced fund' which follows the Prudential Investment Guidelines for retirement funds as laid down in the Pension Funds Act."

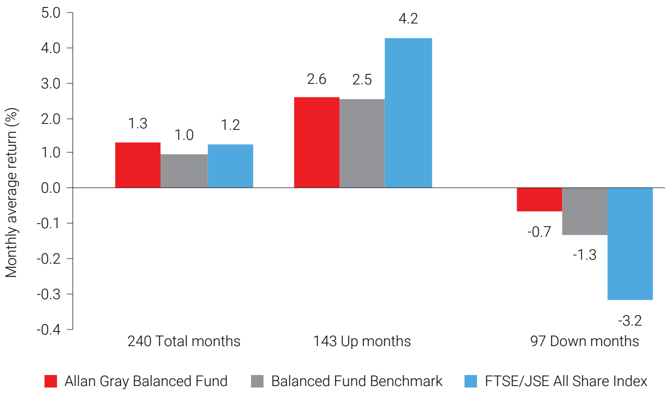
The Balanced Fund continues to be an option for investors looking for long-term growth, but who want to take on less risk than they would with a pure equity fund. And one of its key characteristics is that it aims to protect investors when markets are falling.

Downside protection

Since the founding of Allan Gray, our definition of investment risk has been the risk of permanently losing investor capital.

Our focus on preserving clients' capital in the Balanced Fund means we look to limit participation in negative equity market performance, thus increasing the amount of capital that is available over time to benefit from positive performance. While guarding against downside risk may result in slightly lower returns when markets are running, over time this downside protection has allowed the Balanced Fund to outperform its peer-group benchmark and South African equities (despite the Fund having lower equity exposure) by losing significantly less in negative months, as shown in **Graph 1**.

Graph 1 – The benefit of downside protection



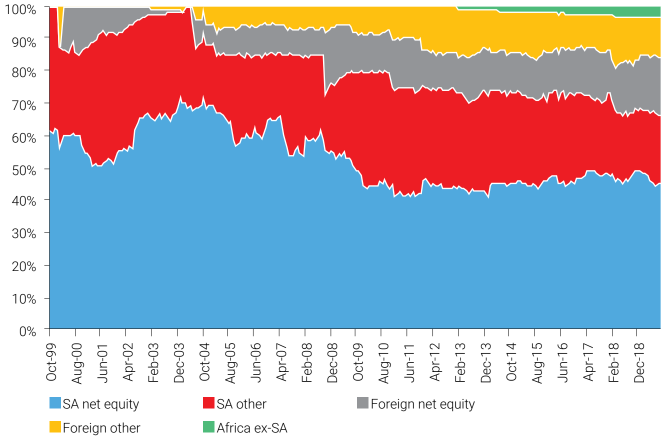
Source: Allan Gray research (data as at 30 September 2019)

Portfolio positioning

The Fund's broad investment mandate allows it to leverage the full potential of our investment philosophy. The portfolio managers build the Fund from the bottom up (within the constraints of the retirement fund regulations), analysing and weighing up the relative attractiveness of individual assets across local and foreign equities, bonds, commodities, properties and cash and investing in the most attractive of those assets that we believe have a reasonable likelihood of producing real returns over the Fund's investment horizon.

Graph 2 (on page 2) shows how the Fund's asset allocation has varied over time. Probably the key difference between the positioning of the Fund now compared to inception is the 30% invested offshore and 3% in African assets outside of South Africa. The exchange control regulations have changed over the years, and the portfolio managers have taken advantage of the opportunity to diversify. While the offshore assets have dragged down performance over the recent past, mainly due to our offshore partner Orbis's stock selection, we believe they add an important diversification element and will add value to the portfolio's performance over the long term. This is explained in more detail on the following page.

Graph 2: Allan Gray Balanced Fund asset allocation (to 30 September 2019)



Source: Allan Gray research

Positioned for multiple outcomes

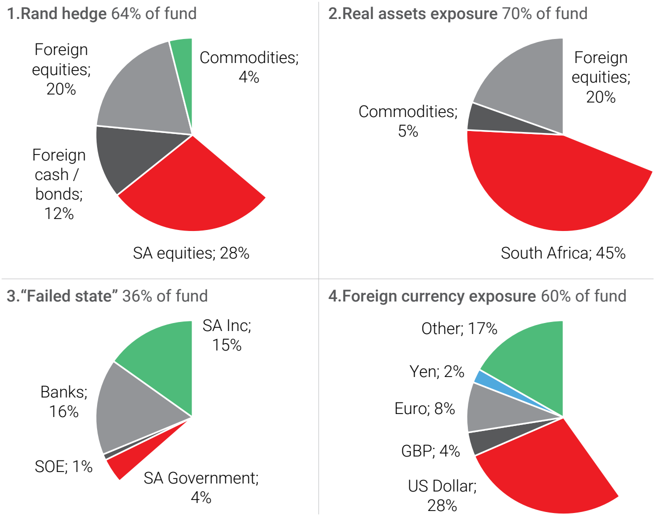
The future is uncertain, and a wide range of potential outcomes is possible. Building well-diversified portfolios that can deliver returns and protect investors from potential negative outcomes is a core part of our portfolio construction efforts and, in our view, illustrates why a Fund launched 20 years ago continues to be relevant today. **Graph 3** shows how the Fund is currently positioned to mitigate various risks prevalent at present:

- Severe rand depreciation: Mitigated by holding rand-hedge assets and ensuring the portfolio is exposed to a range of foreign currencies
  Two-thirds of the portfolio is currently invested in assets that should benefit from rand weakness – i.e. the 30% held offshore and in South African listed businesses that earn their profits offshore. Even though the portfolio is denominated in rands, about 60% of the Fund is exposed to a diversified range of foreign currencies.

- Higher levels of inflation eroding the real value of investments: Mitigated by holding real assets
  Over the long term, cash presents risk, with the key risk being the inability to keep up with inflation. You need real assets to protect against inflation, and 70% of the Fund is invested in real assets.

- A catastrophic decline in the SA economy and the government's ability to finance itself: Mitigated by careful local asset allocation
  The governance and financial challenges in South Africa are well known, as the country desperately hangs on to its investment grade rating. We look carefully for good value opportunities on the local market but are cognisant of the associated risks.

Graph 3: Diversified portfolios for a wide range of potential outcomes

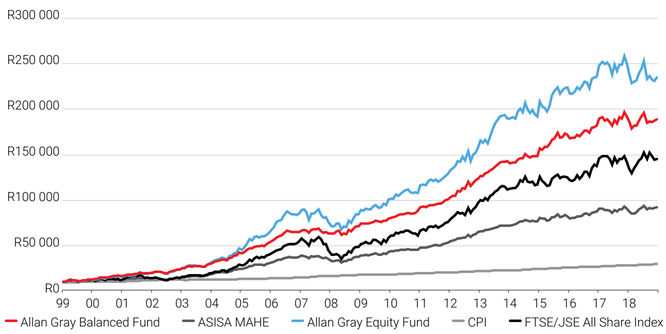


Source: Allan Gray research

Appraising performance

The Balanced Fund has achieved an annualised return of 15.8% since its inception on 1 October 1999. This means that an investment of R10 000 on 1 October 1999 at the opening unit price of R10 would have grown to R189 107.61 after fees and with distributions reinvested at the closing price of R104.72 on 30 September 2019. As shown in **Graph 4**, the average fund in its sector (ASISA Multi-Asset High Equity) achieved an annualised return of 11.8% over the same period, with a R10 000 investment growing to R92 341.00. The same investment in the FTSE/JSE All Share Index (ALSI) would have achieved an annualised return of 14.3%, growing to R145 055.61 (before fees but with dividends reinvested).

Graph 4: Allan Gray Balanced Fund performance (to 30 September 2019)



Source: Allan Gray research

Investing through the cycles

We believe a well-diversified portfolio has many levers to rely on in pursuit of long-term returns, in multiple scenarios, as long as a fair price was paid for those assets to begin with. We have worked hard to structure the Balanced Fund to protect and grow your capital in volatile and unpredictable environments over the last 20 years and will continue to do so into the future.

Commentary contributed by Duncan Artus, portfolio manager, Allan Gray

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