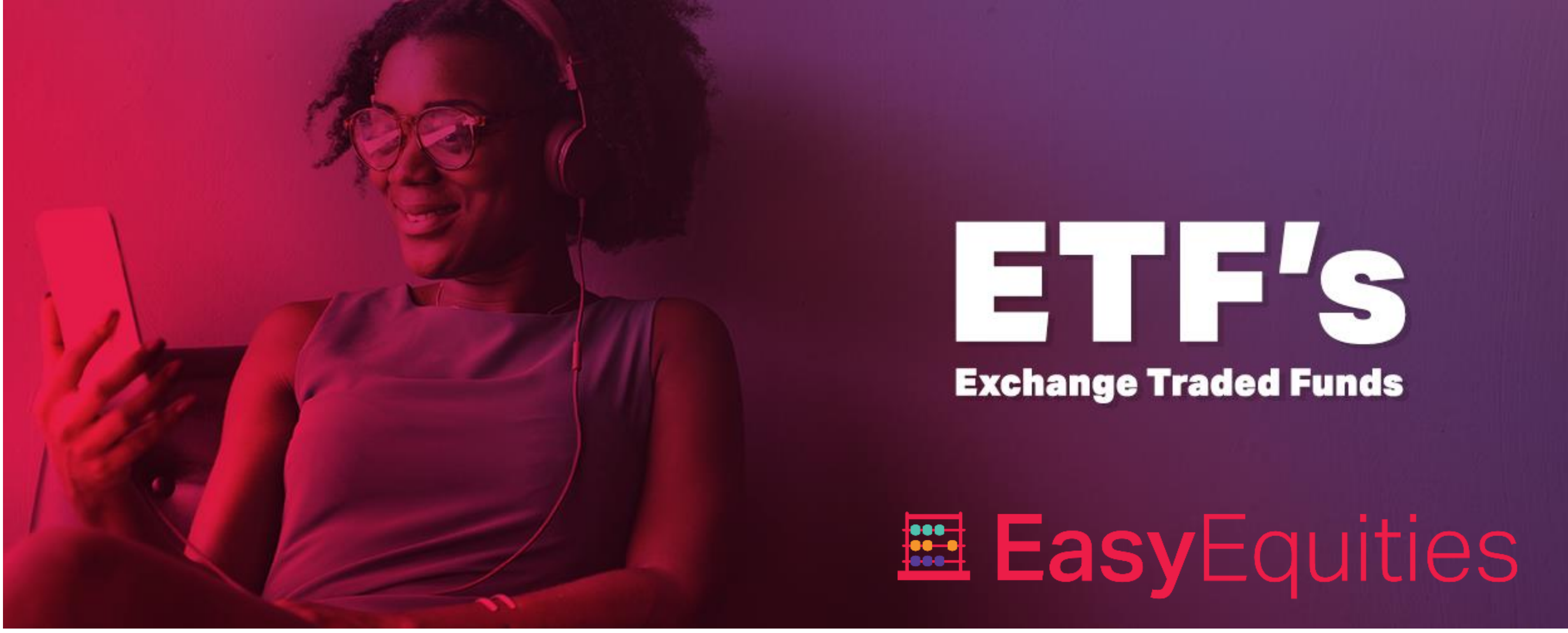


February 2018

# The ETF Monthly Review

***Welcome to the first ETF Monthly Review, a neat monthly 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!***

INSIDE

## What's happened in the markets?

The Ramaphosa effect and Donald Trump's tax cuts triggered a welcome rally in global stock markets.

## Our favourite ETFs

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Foreign equities, developing markets: Satrix MSCI Emerging Markets ETF
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## ETF Investment Thoughts

**Core-satellite strategies:** A good strategy is to rely on ETFs for the "core" of an overall portfolio, but complement it with certain strategic investments that may be short term to take advantage of current conditions.

# Intellidex's favourite ETFs

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

Phibion Makuwerere, CFA, explains:

Generally, we classify all ETFs into five 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 objectives. These are our favourite funds within each of those five broad fund categories.

We believe a good ETF should be cheap. Cost differences, while appearing small on paper, can make a huge impact to 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. To avoid overconcentration, a good ETF should cap its

## *What's happened in the markets?*

The JSE Top 40 index climbed 23% in 2017 with most of the growth coming in the last quarter of the year. Naspers and metals gave impetus to the rally.

Most of the ETFs linked to the JSE Top 40 rose in line with the Top 40 index except CoreShares Equally Weighted Top 40 fund which returned only 13.1%. Meanwhile international ETFs did not fare as well as the strengthening of the rand ate away some of the dollar gains. Although the equities market in the US rose 24.6% in 2017, the Sygnia Itrix MSCI USA ETF managed only 8.91% in rand terms.

In December three ETFs benefited immensely from the ANC conference outcome: Satrix Quality rose 14.65%; Satrix Divi grew 9.38%; and Satrix Fini increased 9.1%. These funds are characterised by banks and retailers which stand to benefit the most from a recovery in SA's economy.

**The international view:**

The surprise last year was the powerful performance of developed markets, particularly the US. They had the best period since the 2008 financial crisis, with both underlying fundamental economic factors looking strong, as well as market levels. This year has started on the same footing, barring some volatility earlier this week.

exposure to a single sector and or a single counter. Below we provide an overview of our favourite funds for each category.

We only change this list when new ETFs are listed, fees change or there is some other material change to the way ETFs work."

**The February favourites:**

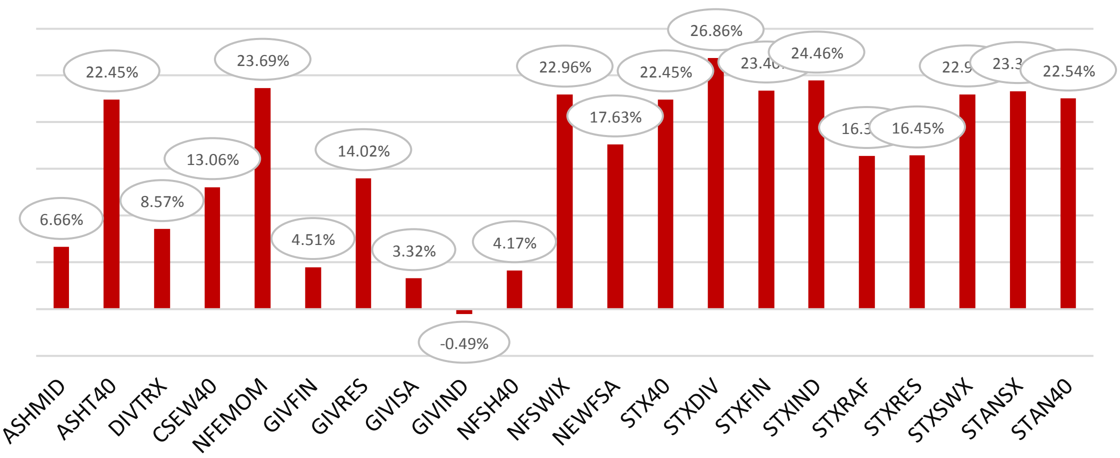
**Domestic equity: Satrix SA Quality ETF**

The fund avoids the concentration risk that has come to dominate the top 40 index as it caps the weight of each counter and sector. We also like its selection criteria (outlined below) and it offers investors potentially more diversified exposure to the entire market.

The fund scores companies using a set of quality metrics, including return on equity, liquidity and the leverage of the balance sheet. The top 20% of all JSE-listed companies with the highest scores based on these criteria are included in the fund. They are then weighted by market capitalisation, capping each at 10% of the fund. The Satrix SA Quality ETF is less than a year old so we can't give a graph of its returns. The other domestic equity funds have tended to deliver returns of over 20% per year for each of the last five years (see Graph 1).

**Graph 1: Domestic equity ETFs: five-year annualised return to end-December**

***(Putting in the full names of the funds would make a mess, so we've used the codes. You can look these up online)***



Last month Japanese factory activity showed its strongest growth in almost four years, while China's Caixin-Markit manufacturing PMI showed slight expansion. In Europe, manufacturing activity continues to be hot, as activity entered the new year with near-record momentum. Regional economic confidence in the eurozone remains close to a 17-year high. However, in January the US manufacturing index slipped marginally to 59.1% from 59.3%, but the IHS Markit manufacturing reading showed that final US PMI held steady at 55.5.

The International Monetary Fund (IMF) estimates that the global economy grew by an estimated 3.7% percent in 2017, which is 0.1 percentage points (pp) faster than projected in September and 0.5pp higher than in 2016. The pickup in growth has been fostered by upside surprises in Europe and Asia. The IMF forecasts that the global economy will grow by an upwardly revised 3.9% for both 2018 and 2019. The upward revision of 0.2pp is supported by increased global growth momentum and the expected windfall from the recently approved US tax policy changes.

On the cost side, Brent crude oil has continued to register significant price gains, maintaining the momentum gathered from last quarter of 2017 as oil-producing nations agreed to extend production cuts to the end of 2018. For SA this will potentially see price increases directly in transport costs and indirectly in other sectors since SA is a net importer of oil.

**The local view:**

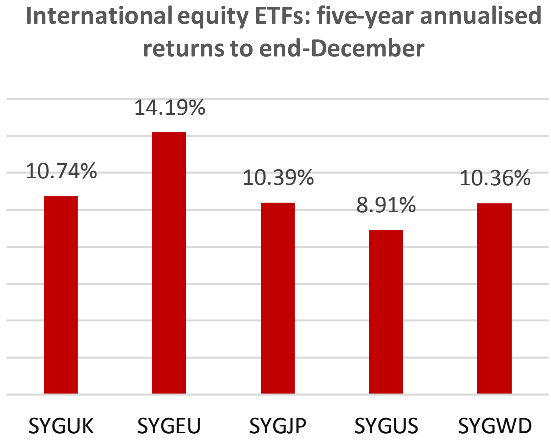
A landmark shift in the leadership occurred at the ANC's elective conference in December, with pro-business Cyril Ramaphosa emerging as ANC's new president. Consequently, a number of market-positive events have unfolded, particularly the closing in on corrupt elements at Eskom. This has seen sentiment improve, helped by a weakening dollar, and the rand has been trading at its best level since 2015. Given the shifting political power, ratings agency Moody's may yet postpone its downgrade of SA debt this month, though the national budget later this month may be a deciding factor. Moody's had put SA on review for a downgrade towards the end of last year.

Although we expect improved business confidence due to Ramaphosa's leadership, the IMF has revised SA's

The outperformance of high-quality stocks is well documented in financial research. Empirical evidence shows that portfolios sorted on factors such as profitability and earnings quality generate high risk-adjusted returns relative to a market portfolio or a multi-factor model. 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**

We've changed this one this month from our previous favourite, the Satrix S&P 500. We've done that to slightly de-emphasise US equities which are currently expensive, in favour of a bigger weighting for Europe and Japan where prospects are improving. But US equities remain the biggest contributor to the fund's returns. We want to maintain US exposure to capitalise on the new tax changes that are likely to benefit companies. However, as an alternative, and perhaps to lock in your US gains, Sygnia's Itrix Euro Stoxx 50 ETF is our second favourite as it is set to benefit from the eurozone's economic recovery.




The Ashburton Global 1200 ETF tracks the S&P Global 1200 index, which in turn tracks seven global indices based on their free-float market capitalisation: 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. The Sygnia Itrix Euro Stoxx 50 ETF tracks the Euro Stoxx 50 index which is made economic growth forecast downwards for 2018 and 2019, citing rising political uncertainty which it says weighs on confidence and investment. It projects the economy to grow by 0.9% over the next two years, down from its October projections of 1.1% for this year and 1.6% for 2019. We expect local growth to be driven by a recovery of retailers, banks and mining companies.

Corruption has not only been limited to government; retail giant Steinhoff came crashing down following the uncovering of accounting shenanigans and the resignation of its high-profile chief executive, Markus Jooste. Steinhoff has since given up close to 90% of its market capitalisation since the chilling revelation in December. It does not end there, Viceroy a hitherto unknown research firm which released a report corroborating the Steinhoff scandal immediately after it was uncovered, recently issued another damning report on one of SA's banking success stories, Capitec. Although there is still some anxiety among investors as a result of the report,

of the 50 largest and most liquid blue chip stocks from countries within the eurozone.

**Foreign equities, developing markets: Satrix MSCI Emerging Markets ETF**

This 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 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. There are now six listed funds in this category:

1. NewFunds GOVI ETF
2. NewFunds ILBI ETF
3. NewFunds TRACI 3 Month ETF

ETF Investment Thoughts

## Using core-satellite strategies

ETFs are usually long term strategic building blocks to an investor's core portfolio. They usually have wide exposures to the market, so offer some diversification.

One good strategy is to rely on ETFs for the "core" of one's overall portfolio, but then complement it with certain strategic investments that may be short term to take advantage of current conditions.

We have two ideas for tactical satellite portfolio allocation in current markets:

The first idea is underpinned by rand's recent gains against the dollar and the rise of tech firms as the world gets more automated. We think it's an opportune time to create a satellite exposure using Sygnia's Itrix 4th Industrial Revolution Global Equity ETF. In addition to its rand hedge properties, the ETF is characterised by stocks with exposure to technologies such as autonomous vehicles, cleantech, drones, 3D printing, robotics, nanotechnology, smart buildings and virtual reality.

If you don't buy into in the tech rhetoric, our second idea is informed by the seismic shift taking place in SA's political landscape. We believe Ramaphosa leadership of the ANC and possibly of the country will help pull the economy out of its decade-long low-growth mode and companies that are heavily exposed to the SA economy are set to benefit. Ashburton's mid-cap fund is characterised by such companies. Adding the fund to your portfolio would be a way to take advantage of the current sentiment.

prominent authorities including the SA Reserve Bank and rating agency Standard & Poor's have come out in defence of the bank's integrity.

Another topical issue that investors ought to keep an eye on is the apparent lack of diversification on the JSE with performance significantly driven by a few giants such as Naspers and Richemont. This raises concentration risk for index investors such as ETFs, a factor that we consider when choosing our favourites.

4. Ashburton Government Inflation ETF
5. Satrix ILBI ETF (recently listed fund)
6. CoreShares PrefTrax

They each track different things: 1 tracks government bonds; 2, 4 & 5 track inflation-linked government bonds; 3 tracks short-term money market instruments; and 6 tracks listed preference shares.

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.

However, for a longer investment horizon, the motivation is to protect your investment against inflation. Because the **Satrix ILBI ETF** promises to have the lowest expense ratio of 0.22%, it is our choice here. It does not have a performance history as it was launched only recently but should mimic the performance of other inflation-linked bond funds.

**Bonds and cash ETFs: five-year annualised return to end-December**