An in-depth look at SA Income Funds:
Navigating both variety and complexity

Morningstar Investment Management South Africa
December 2023

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For Financial Advisors and their Clients

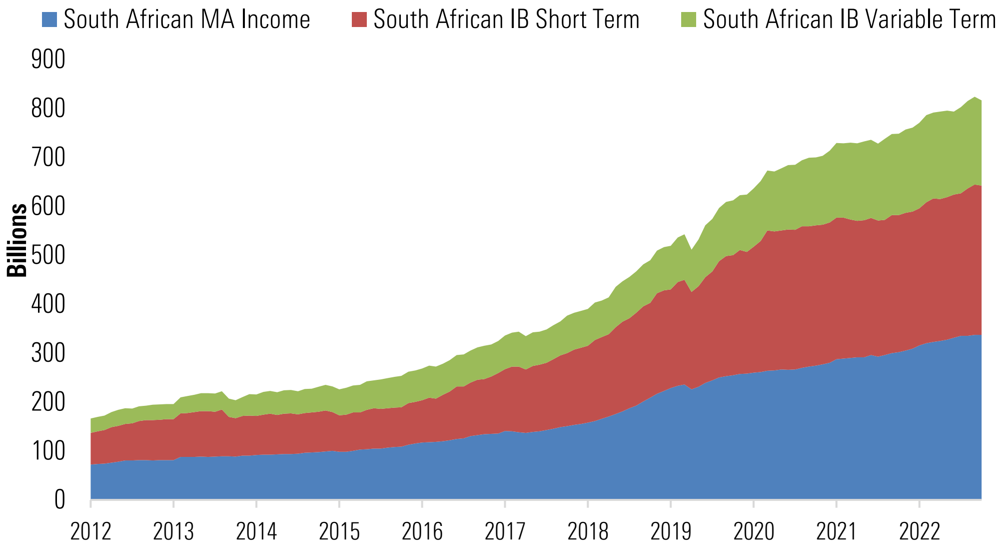
Key Takeaways

- Income funds remain an important part of an investor's toolkit, with this space having seen significant growth in assets and fund options over the last few years.
- With a range of different fund options to choose from, that employ a range of different strategies, selecting the right income funds for investors' needs has become a more challenging task.
- Understanding the risk characteristics of these funds, and subsequent return expectations, is key for investors.

Fixed Income funds continue to be an incredibly popular and important component of South African investors' portfolios. South African Fixed Income funds, as categorised by Morningstar's Global Broad Category Group classification, have seen net inflows in every single calendar year period over the last decade.

As can be seen in Exhibit 1 below, assets in the Association for Savings and Investment South Africa's (ASISA) three largest Fixed Income fund categories have grown from a collective R167-billion (at the end of 2012) to R817 billion (as at the end of September 2023). This is an annualised growth rate of 16% that far outstrips the annualised 6.7% return generated by the FTSE/JSE All Bond Index (ALBI) over the same time.

Exhibit 1 | Total net assets by ASISA Fixed Income fund category

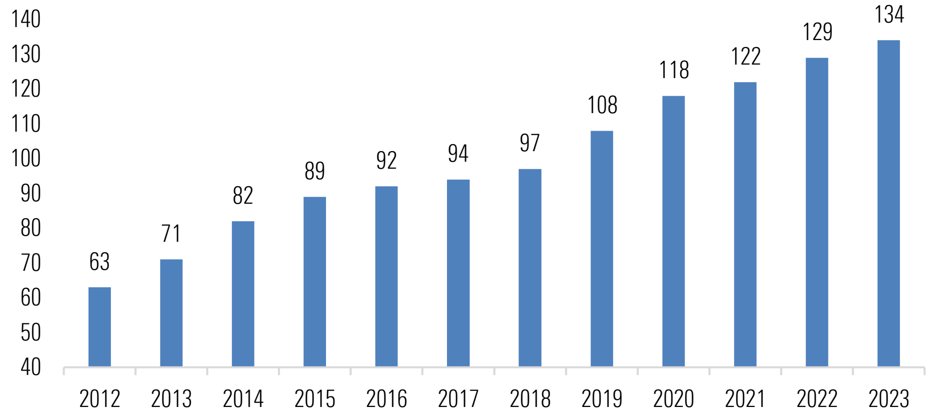


Source: Morningstar Direct Asset Flows. Data as at 30 September 2023. Market: South Africa Open-end excluding FoF (domiciled). Past performance is not a reliable guide to future performance. For illustrative purposes only and not indicative of any investment.

As the assets being invested into the local fixed income space have grown, so too have the number of fund options available to investors. In particular, ASISA's South African Multi-Asset Income fund category has proven to be a popular area for asset management firms to launch new fund offerings in the hopes of capturing some of these positive asset flows.

This category is the largest of these three ASISA Fixed Income categories by assets and offers the greatest flexibility for Fixed Income fund managers. The category has seen consistent new fund launches year after year, with the number of unique funds in the category effectively doubling over the last decade - growing from 63 (at the end of 2012) to 134 (as at the end of September 2023).

Exhibit 2 | Number of funds in the ASISA South African Multi-Asset Income category



Source: Morningstar Direct. Data as at 30 September 2023. Market: South Africa Open-End Funds, ASISA Sector (South Africa) = (ASISA) South African MA Income, Oldest Share Class. Past performance is not a reliable guide to future performance. For illustrative purposes only and not indicative of any investment.

The rise in popularity of income funds in South Africa

Generally, the rise in popularity of income funds in the South African market over the last few years can be attributed to a few things.

- **Firstly**, in a recent period where interest rates have been at record low levels, both globally and in South Africa, the subsequent yields and rates of return generated by Money Market funds have been unexciting when compared to those that are on offer from Income funds that operate slightly higher up the risk spectrum.
- **Secondly**, the last decade has also been a disappointing period for South African investors in more traditional multi-asset class portfolios. Investors have seen similar return outcomes from Low Equity Multi-Asset funds and Income funds over the last decade. However, the appeal in income funds has been that those returns have generally been delivered with a lower volatility.

Against this backdrop of increased popularity and a vastly increased number of options, interested investors are left with the conundrum of figuring out which income fund is going to be the right one for their needs. As this article will highlight, this is not the simple task that investors may think it is.

In the South African Multi-Asset Income category, in particular, investors must sort through funds that can, and do, employ a range of different strategies to generate returns. As such, not all of these strategies are directly comparable in terms of their return and risk characteristics that their grouping in the same ASISA fund category might suggest.

To add to the complexity, the naming conventions of these income funds do little to provide clarity to investors about the type of strategy that is being employed. Popular descriptions or names for income funds commonly use 'Enhanced', 'Flexible' or 'Diversified', but the risk and return characteristics of one manager's 'Enhanced Income Fund' can look very different to another's 'Enhanced Income Fund'.

The word cloud in Exhibit 3 below illustrates the frequency of words used in the naming of different funds in the ASISA South African Multi-Asset Income category to highlight the range of descriptors for these funds where the larger the word is in the image, the more frequently it is used in fund names.

Exhibit 3 | Prevalence of words used in ASISA South African Multi-Asset Income fund names

Source: Morningstar Direct, author's calculations. Word cloud generated using WordItOut.com. Data as at 30 September 2023. Market: South Africa Open-End Funds, ASISA Sector (South Africa) = (ASISA) South African MA Income, Oldest Share Class. For illustrative purposes only and not indicative of any investment.

Understanding the main ASISA Fixed Income fund categories

While ASISA has several different fund categories, outside of Money Market funds there are three categories in which the bulk of the South African Fixed Income category assets are invested:

South African - Interest Bearing – Short Term:

- Interest Bearing portfolios invest exclusively in bonds, money market investments and other interest-earning securities. They may not invest in equity securities, real estate securities or preference shares.
- To provide relative capital stability, the weighted average modified duration of these portfolios is limited to a maximum of two years.

- Funds in this ASISA category should be less volatile and are characterised by a regular and high level of income.
- The funds are typically benchmarked against a cash benchmark, such as the STEFI Composite Index.

South African - Interest Bearing – Variable Term:

- Similar to the above, as these are Interest Bearing portfolios they also invest exclusively in bonds, fixed deposits and other interest-earning securities.
- However, there is no duration limit on these portfolios and they may invest in short, intermediate and long-dated securities.
- Funds in this category will be more volatile than those in the above Short Term category, as they also offer the potential for capital growth/loss together with regular and high levels of income.
- These funds are typically benchmarked against a relevant bond index, such as the FTSE/JSE All Bond Index.

South African - Multi-Asset – Income:

- Multi-Asset Income portfolios have a far greater range of flexibility than the Interest Bearing portfolios do. These portfolios invest in a spectrum of equity, bond, money market, or real estate markets with the primary objective of maximising income.
- These portfolios can have a maximum effective equity exposure (including international equity) of up to 10% and a maximum effective property exposure (including international property) of up to 25%.
- There are no duration limits and the risk and return objectives of individual portfolios can vary as dictated by each portfolio's mandate and stated investment objective and strategy.
- Given the flexibility and range of different strategies the funds in this category have a range of different benchmarks, which include cash and cash-plus benchmarks, bond index benchmarks, CPI benchmarks and category averages.

The appeal to asset managers for launching Income funds in the Multi-Asset Income fund category is clear. The category has fewer limitations than the Interest Bearing categories and, thus, provides greater flexibility to asset managers to manage their portfolios. It also provides managers with a far broader toolkit in terms of the range of asset classes at their disposal.

It is debatable, though, whether the average conservative investor who is a would-be user of Income funds would want, or expect, relatively more volatile asset classes such as equity and listed property to be present in their portfolios.

Recent regulatory changes to offshore limits also increase the flexibility that fund managers have at their disposal. At the same time, these changes also make risk management considerations around currency management an imperative for managers to consider. The Rand is a notoriously volatile currency, and so any unhedged offshore exposure could potentially bring unwanted volatility to income fund portfolios that are expected to provide investors with a somewhat smoother ride.

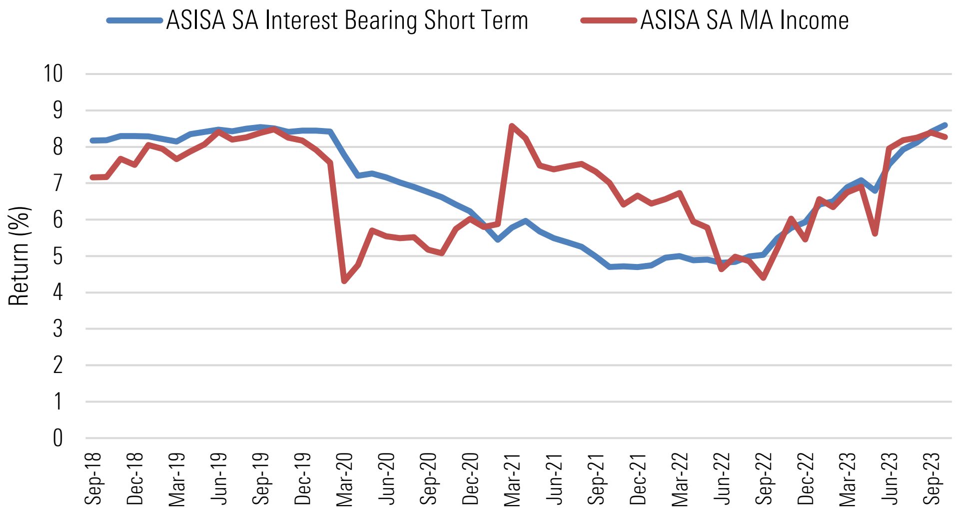
For ASISA's South African Multi-Asset Income fund category the regulatory 45% offshore maximum also potentially introduces an additional classification concern to be considered. Theoretically, a South African Multi-Asset Income Fund could hold as little as 20% of its assets in domestic fixed income instruments, with the balance being held in the maximum limits of 45% offshore, 25% in property and 10% in equity, and still be classified as a South African Income fund. It is, again, debatable whether this sort of outcome would align with investors' expectations when investing in what is meant to be a conservative fund category.

Focusing on the South African Multi-Asset Income category

Given the popularity of the category and the diverse range of strategies it houses, the South African Multi-Asset Income fund category requires some further scrutiny. In an environment where local rand-denominated assets have generally underperformed, it's important to understand if the greater flexibility available to fund managers in this category has generally benefitted investors.

Exhibit 4 below shows the average performance of the South African Multi-Asset Income category versus the more conservative South African Interest Bearing Short Term peer set.

Exhibit 4 | Rolling 12-month Category Average Returns for the ASISA South African Interest Bearing Short Term and ASISA South African Multi-Asset Income fund categories



Source: Morningstar Direct, author's calculations. Data as at 31 October 2023. Market: South Africa Open-End Funds, Oldest Share Class. Past performance is not a reliable guide to future performance. For illustrative purposes only and not indicative of any investment.

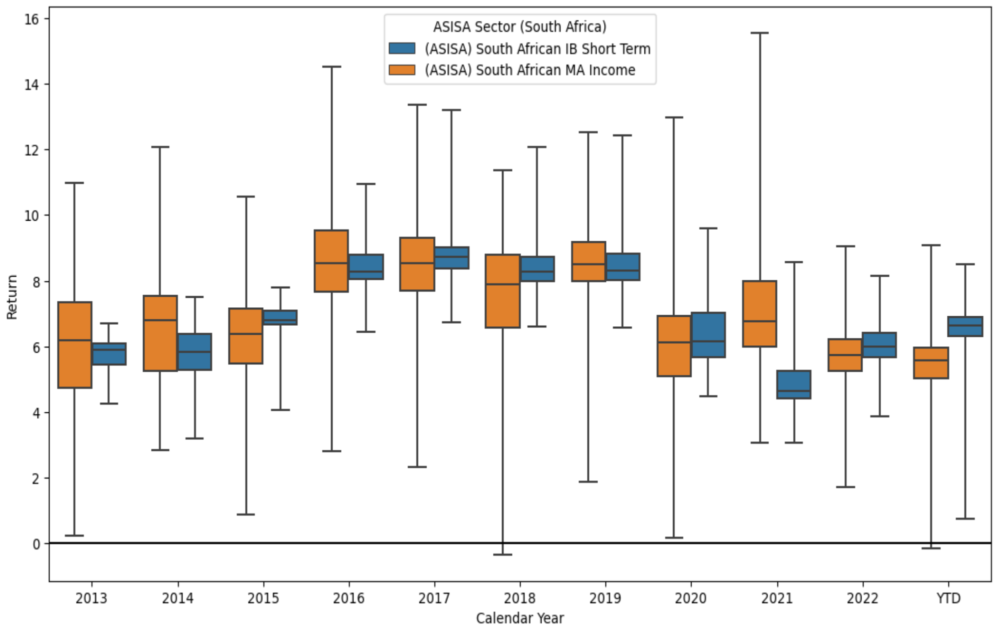
The average South African Multi-Asset Income fund is shown to deliver performance approximately in line with more conservatively managed South African Interest Bearing Short Term peers over the last five years.

The Multi-Asset Income category has also experienced greater volatility and deeper drawdowns during market shocks like the COVID-19 induced market selloff in 2020. Returns of the Interest Bearing Short Term category are more closely aligned with the interest rate cycle, falling gradually as rates were cut post-pandemic and rising as interest rates have normalised towards higher levels this year.

While the average returns delivered by both fund categories appear to show little differentiation, it is also worth highlighting the diverse range of return outcomes delivered by funds in the South African Multi-Asset Income fund category in particular. Exhibit 5 below depicts a box-and-whisker plot showing the range of returns delivered by funds in both the ASISA South African Multi-Asset Income fund category (which has a large amount of flexibility) and the ASISA South African Interest Bearing Short Term fund category (which has tighter limitations on asset classes and portfolio duration).

The boxes in the chart depict the second and third quartiles of the categories, with the bisecting line showing the median observation for the period. The whiskers, which extend upwards and downwards from the boxes, depict the full range of observations per fund category and time period from the maximum return observed to the minimum.

Exhibit 5 | Box-and-whisker plot showing the distribution of calendar year returns for the ASISA South African Interest Bearing Short Term and ASISA South African Multi-Asset Income fund categories



Source: Morningstar Direct, author's calculations. Boxplot generated using Python and Seaborn. Data as at 30 September 2023. Market: South Africa Open-End Funds, Oldest Share Class. Past performance is not a reliable guide to future performance. For illustrative purposes only and not indicative of any investment.

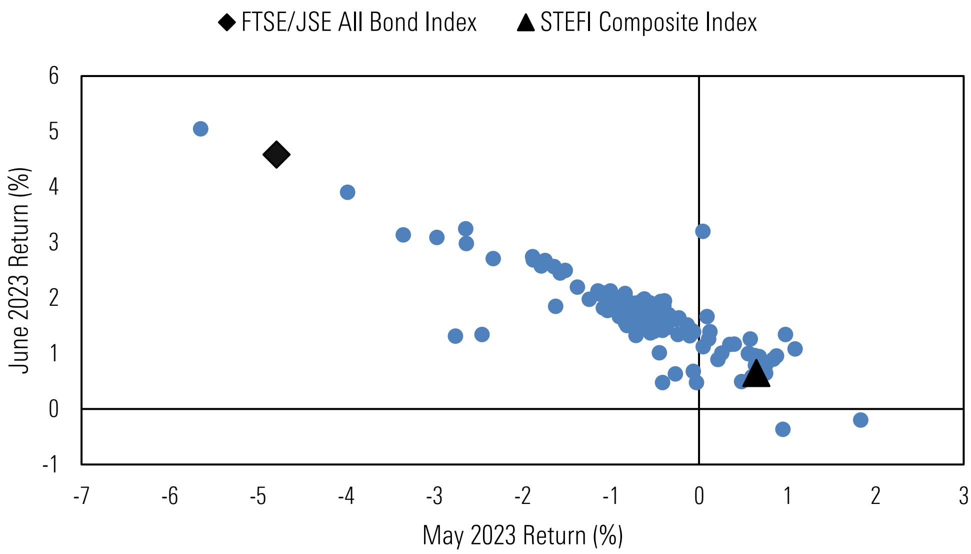
What can be seen in the chart is a far wider range of outcomes for funds in the Multi-Asset Income category. By way of illustration, the calendar year of 2020 is an interesting case study.

In 2020 the median fund return in both fund categories was roughly the same: 6.16% for the Interest Bearing Short Term category and 6.13% for the Multi-Asset Income category. However, the range of outcomes for the Multi-Asset Income category in 2020 was far more dispersed, with the top-performing fund in this category returning 12.97% and the worst-performing fund returning a mere 0.16%.

A useful exercise that can aid in visualising and understanding the range of different strategies in the Multi-Asset Income category is to analyse how those funds in the category perform in times of bond market stress.

The bond market environment of May and June of 2023 provide us with an interesting set of results for this exercise, where the ALBI declined by -4.8% in May 2023 before rebounding +4.6% in June 2023. Exhibit 6 below demonstrates the monthly returns of all funds in the Multi-Asset Income category in those two months.

Exhibit 6 | Monthly returns for May 2023 and June 2023 for ASISA South African Multi-Asset Income funds



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The visual above leads to some interesting observations:

- **Firstly**, while most fund returns in the category were negative in May 2023 there was a range of different drawdown experiences. While all but one of the funds did better than the ALBI for the month, those with longer duration positions and more bond exposure would have experienced drawdowns commensurate with that of the bond market.

Typically these funds bounced back with similar vigour in June 2023 when the local bond market recovered. Nonetheless, it highlights some of the volatility that these types of funds can experience.

- **Secondly**, there were several funds that produced positive return outcomes in both months. These funds fall broadly into two types of approaches: defensive managers with shorter duration profiles and managers who are making extensive use of credit instruments that may not mark-to-market regularly.

  On the latter, the South African credit market has well-documented liquidity issues. As a result, credit instruments held in Income fund portfolios do not reprice frequently, or sometimes at all, as they often do not trade.

  Depending on the nature of what is being held, for funds that hold a significant amount of credit in portfolios this can paint a somewhat misleading picture of a portfolio's risk and return. Particularly if risk is assessed through the lens of volatility.

- **Finally**, the chart also highlights a few outliers that seem to fall outside of the expected pattern that is present in the chart. On closer inspection, these outliers are funds that run strategies that are quite different from a traditional Income fund, but likely find themselves in this particular fund category because of its wide flexibility and because ASISA does not have a fund category that caters specifically to these mandates. Such strategies include Inflation-Linked Bond funds and Shariah-compliant Income funds, which also form part of the South African Multi-Asset Income category.

In short, the flexibility allowed by the ASISA South African Multi-Asset Income category has made the category a difficult one for investors to navigate. The range of strategies on offer within the category makes comparability challenging, and we would urge investors to look beyond a fund's naming conventions and categorisation when looking for an Income fund that fits their specific needs.

What should investors look out for when selecting an Income fund?

At Morningstar we evaluate funds based on five key pillars: Process, Performance, People, Parent, and Price. These pillars form the backbone of our manager research approach and are the five key areas that Morningstar's global analyst team has identified as crucial in predicting the future success of funds.

Specific to South African Income funds, it is important to understand just how a manager aims to generate their returns and the risks that are being taken to get there. Given the flexibility that the category allows, a South African Multi-Asset Income fund has a few different return levers that a manager can pull in looking to generate returns, including asset allocation, duration, credit and liquidity.

Understanding how a manager makes use of these levers of return should provide an investor with a clearer picture of what the performance profile of such a fund would be expected to look like:

- **Asset allocation:** This is the exposure that the portfolio has to different asset classes at a given point in time. It is a mandatory disclosure, as per Board Notice 92 of 2014, on a fund's Minimum Disclosure Document (MDD) – or what is commonly known as a 'Fund Fact Sheet'.

  While not all asset managers' disclosures are the same, an investor should ideally be getting line of sight into the fund's exposure by instrument type for both domestic and offshore assets in the fund's MDD. For an Income fund, it can provide valuable information about the makeup of the fund which can give insights into the fund's risk characteristics, particularly if the fund has exposure to more volatile assets such as equities and listed property stocks.

- **Duration:** This is a risk measure, usually expressed as a number of years, that provides an indication as to the interest rate sensitivity of a portfolio. The higher (or longer) a portfolio's duration, the more sensitive it is to a change in interest rates (or yields).

  While duration is a point-in-time measure, it can also be extremely useful to see how a fund's duration has changed over time as this can provide insight into how a fund manager makes use of duration as a lever of return in their fund. Unfortunately, the disclosure of a fund's duration in MDDs is not a mandatory requirement, though it is encouraging to see that some asset management firms are proactively disclosing this key risk metric to investors in their fund literature.

- **Credit:** This generally refers to the exposure the fund holds to issuers outside of sovereign government bonds. These types of instruments typically trade at a spread above the sovereign yield curve and investors are typically compensated for taking on credit risk with an additional yield pickup.

  The types of issuer and credit exposure can vary widely, but in South Africa's fairly limited credit market, the issuer exposure is typically to banks, state-owned enterprises and corporates. There are several factors to consider in assessing a fund's credit exposure, including the credit quality (usually denoted by a credit rating), the seniority of the credit exposure (denoting where the issuance sits in a firm's capital structure) and the diversification of issuers.

  Understanding how an Income fund makes use of credit and the type of credit exposure it holds can provide investors with valuable insight into how the fund is managed. Again, the disclosure of a fund's credit characteristics is not a mandatory requirement, but some managers do a better job of disclosing this information than others. Additionally, a recent trend among South African Income fund managers is the use of credit-linked notes in portfolios. These can often be opaque structures, and it would be in investors' interests for them to know who the underlying reference entity is for these types of credit instruments.

- **Liquidity:** In simple terms, a portfolio's liquidity refers to the ease at which an asset can be converted into cash without affecting its market price.

  As compensation for investing in relatively illiquid instruments, investors are usually rewarded with higher returns via an illiquidity premium. In the case of the nature of an Income fund, liquidity is of paramount importance and is quite closely linked with the asset allocation and credit levers mentioned above.

  A South African Income fund could hold some illiquid assets that a manager could struggle to sell from their portfolio, or be forced to sell at an unfavourable price, should a big liquidity event occur. Once again, improved and more granular disclosure would assist investors in understanding the liquidity profiles of the Income funds they are potentially invested in.

In conclusion

As is clearly evident from the growth in the fund category, Income funds remain an extremely popular and essential tool in an investor's toolkit. However, given the range of Income fund strategies that are out there, the task of picking out a fund that meets an investor's specific needs and expectations in this space could prove to be a slightly more challenging task than one might anticipate.

This article hopefully provides a useful starting point for investors in understanding the South African landscape of Income funds. Ultimately, as investors in a number of these funds, understanding their risk characteristics and subsequent return expectations is key. We believe that these are best understood by assessing the levers of return that managers can pull and how managers use these levers to construct their funds.

As multi-asset investors, Morningstar considers the prospects for all asset classes when building client portfolios. More specifically, we strive to build holistic portfolios that provide diversified payoff profiles to mitigate potential short-term outcomes compromising long-term investment objectives.

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