OUR TWO CENTS

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The Interest Rate Cycle and Income Funds

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Paul Fouché is the Chief Investment Officer and co-founder of New Road Capital. Paul has a wealth of experience in the financial advisory and investment management industry, from client facing advisory roles to the technical aspects of portfolio management and asset allocation. After graduating with an Honours Degree in Chemical Engineering from the University of Pretoria in 2007, Paul started his career as a production manager in the manufacturing industry. In 2010, he joined the Liberty Group as a financial planner focusing on constructing portfolios for high net-worth clients. This is where he and Garth met and formed their friendship. Paul moved into a management role, whereby he managed a team of financial advisers and built up a large client investment book. During this time Paul obtained his CFA charter, and in 2016 he entered the private wealth management industry whereby he managed personal share portfolios and model portfolios for high net-worth clients. In 2019 he co-founded New Road Capital with Garth, as a business that could materialize their vision of providing holistic and unique portfolio management services to financial advisers and their end clients.

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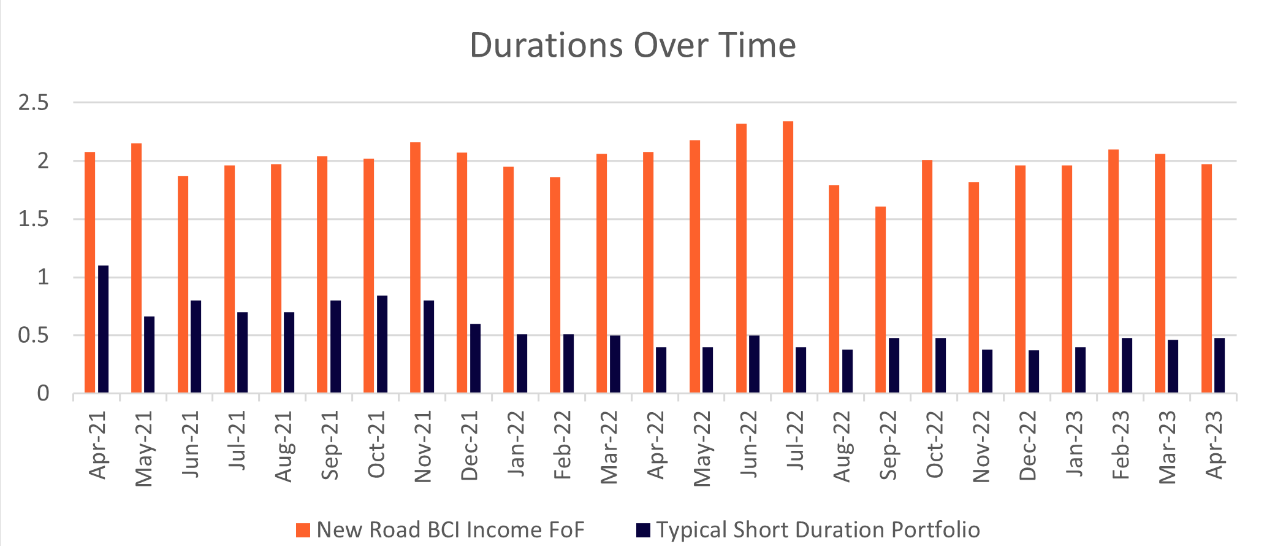
Michael joined as an investment analyst and has an MPhil (Financial Management Sciences) cum laude specialising in economic psychology and has passed the CFA level 2 exam. Prior to starting at New Road Capital, he worked as assistant lecturer at the University of Pretoria assisting with quantitative investment analysis. He has built and traded on models using CFDs. Outside of work, he enjoys flying motor gliders from Springs airfield as well as sailing his Laser class sailboat.

Money market instruments have always been useful for conservative investors who place great focus on capital stability. These stable returns, however, do come at a cost as expected money market returns are lower than their more volatile interest earning counterparts. It is for this reason that investors are normally advised to limit the use of money market funds to very short-term investments, i.e., a couple of months, while longer term income investments should be made in higher yielding assets, as their longer-term return is more important than their shorter-term volatility.

Over the past year, central banks around the world have steadily increased interest rates in their effort to slow down inflation. This impacts interest bearing portfolios in two ways, the first being an increase in yield and the second being a decrease in the capital value of the portfolio. The strength of this effect is dependent on what is referred to as the duration of the portfolio, where a longer duration portfolio will be affected more heavily than a shorter duration portfolio. This results in a trade-off between the higher yield earned and the lower capital value of the portfolio as interest rates increase.

The New Road BCI Income Fund of Funds (Income fund) is a multi-asset income fund, meaning that it can invest in a variety of different income generating assets ranging from money market at the low end to government bonds at the high end. The fund's assets are constantly being managed between these different asset classes in order to achieve a balance between generating sufficiently attractive returns while managing volatility. Our specific goal for the strategy is to ensure that clients earn a sufficient amount of income over the full course of their investment horizons, but in order to do this we need to take on a small amount of volatility to achieve these returns.

The Income fund differs from both money market funds as well as credit only funds, which invest in longer term bank paper and corporate credit and are typical shorter duration in nature. However, the Income fund still uses these asset classes in its larger portfolio construction. As you can see in the below graph, the Income fund's duration changes over time, but it is still higher on average than a typical shorter duration portfolio. This additional volatility results in superior performance over time when long term yields are higher than short term yields.

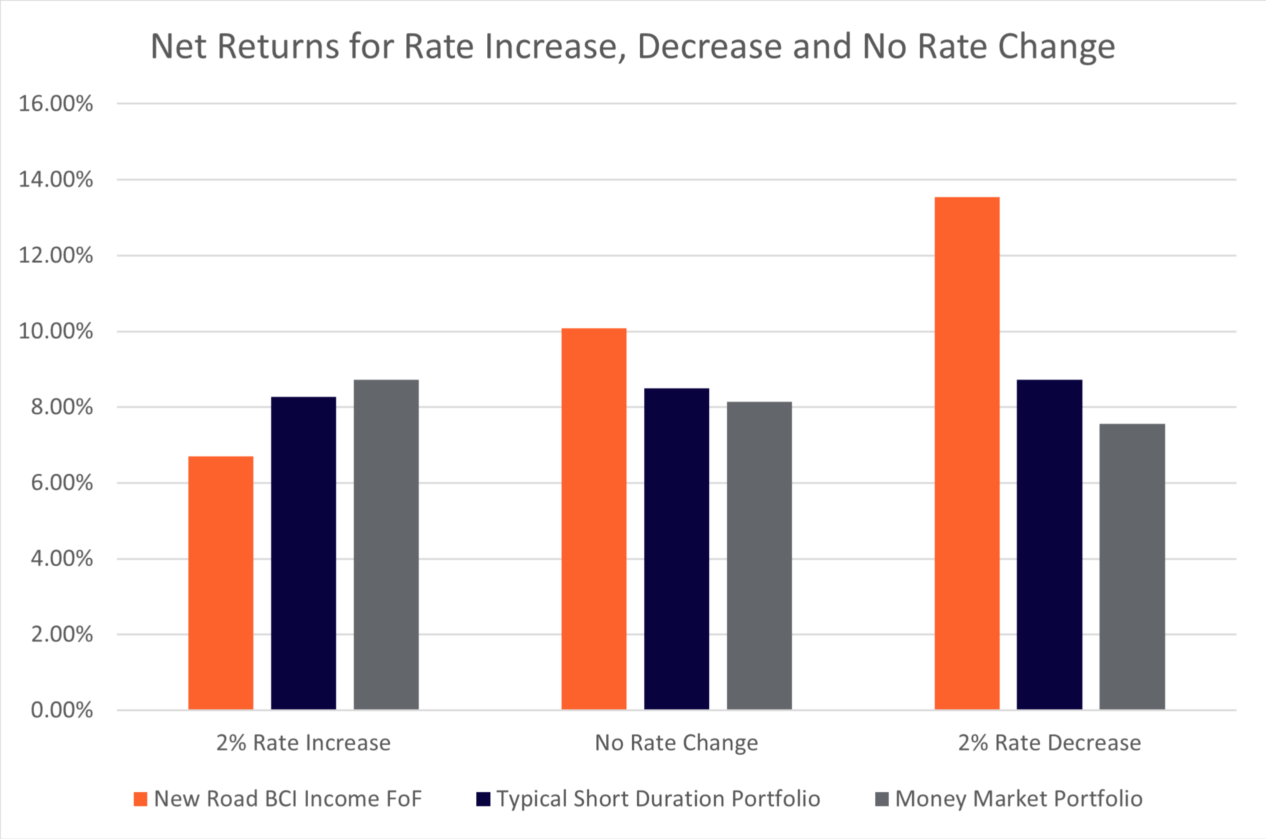


Source: New Road Capital

The current yield on the Income fund is the highest it has been since inception, with a gross yield of 10.6%. The duration on the other hand is about average at 1.97%. We believe that this creates a very compelling opportunity for forward returns in the fund, specifically from a risk adjusted point of view. The question is, to what extent will returns be affected if rates continue to rise?

To illustrate this, we have created a future scenario where rates continue to increase by 200bps over the next year, i.e., a 50bps increase for each of the next 4 quarters. We have also included scenarios where there is no change in rates as well as a scenario in which rates decrease by 200bps over the next year.

We have done this for the Income fund as well as for a typical short duration portfolio and a typical money market portfolio. Returns are net of fees.



Source: New Road Capital. Scenarios are based on current fund yields and durations. These can and do change over time depending on market dynamics.

Due to the extremely high yields currently on offer, there is a clear asymmetry between the effects of an increase in rates when compared to a decrease in rates on the returns of the 3 portfolios. Should rates increase over the year, an investor in the Income fund would return about 6.5% as the effect of the high yields would be offset to a greater extent by the capital reduction in the portfolio. The money market portfolio would return the most at around 8.5% due to the increase in yields. In essence, the Income fund investor would earn 2% less as a result of this interest rate move. However, if returns stayed the same, or started to decrease, the Income fund returns would be vastly superior to the returns on both other portfolios. In the no rate change scenario, the superior yield would translate into a superior return, and in the rate reduction scenario, the superior yield would be supported further by an increase in capital that would be larger in effect due to the higher duration of the portfolio. This would result in a return of 13.5% in the Income fund vs. 7.5% in the money market portfolio. A difference of 6%!

Further to this, in order for the net return of the money market portfolio to be equal to the Income fund over the next year, rates would need to increase by 25bps each quarter resulting in a total increase of 100bps.

Which of these scenarios is more probable is still uncertain at this stage, however the effects of the recent interest rate hikes are now showing in the inflation figures, particularly for the US and Europe. It is expected that further rate hikes are unlikely and that there is a possibility of rate decreases in the near future. In the monetary policy statement released by the South African Reserve Bank in May, the expectation by the SARB is that interest rates may be cut as soon as the end of 2023, with rates projected to be around 1.25% lower when steady state conditions are reached in 2025. It is therefore substantially more likely that the future environment will more closely resemble something in between the unchanged and decreased interest rate scenarios than the increased interest rate scenarios.

Based on this, there is more benefit to holding a fund with enough duration to capture the capital movements and current high yields than there is to being too conservative.

By: Paul Fouché & Michael Caroline