# Investing in Uncertain Times – It's worth Exploring the Alternatives to Money Market Funds

By Conway Williams Prescient Head of Credit; PM, Siphokuhle Zwane Prescient Quantitative Analyst

August 2024

Investing in South Africa's fixed-income market amid various uncertainties, socio-economic issues, elevated yields, and sluggish growth can be challenging. In times of uncertainty, many investors' first instinct is to put their savings into safe-haven funds like money market funds, not considering other investment opportunities that will provide them with better returns.

While money market funds have played an important role during the recent hiking cycle, there are real alternatives worthy of serious consideration for investors seeking risk-adjusted returns. Flexible income funds, for example, can be a compelling option, offering flexibility, diversification and capital preservation, with volatility thoroughly considered and risks carefully managed.

Flexible income funds aim to optimise income-generating potential and safeguard capital by dynamically allocating assets across various classes. By investing in a variety of income-generating assets, these funds generate higher levels of income than money market funds and, while being risk-conscious, generally offer better returns in excess of cash.

Unlike traditional fixed-income funds, flexible income funds are not restricted to a single asset class. They can invest in bonds, equities, property, preference shares, inflation-linked bonds, derivatives, and offshore cash and bonds. This bigger universe of asset classes gives fund managers the flexibility to adjust allocations based on shifting market conditions, enabling them to maximise returns while protecting capital.

Popular for their versatility and performance, flexible income funds have experienced significant growth to the point where they command a significant proportion of the assets under management in the South African investment landscape. The latest industry statistics show that the size of the ASISA Multi-Asset Income category, a proxy for income funds representing 134 different funds, grew to about R380 billion assets under management by the end of June this year from R312 billion as at the end of June 2023. This 22% year-on-year growth in the category underscores investors' confidence in these funds' ability to navigate complex market environments and deliver consistent returns.

Our research suggests that return targets for these funds typically range from 1% to 4% above inflation over the medium to long term, delivering on their aim to deliver returns above cash. This objective is achieved through active management and strategic allocation across various income-generating assets.

Why invest in income funds instead of money market funds now?

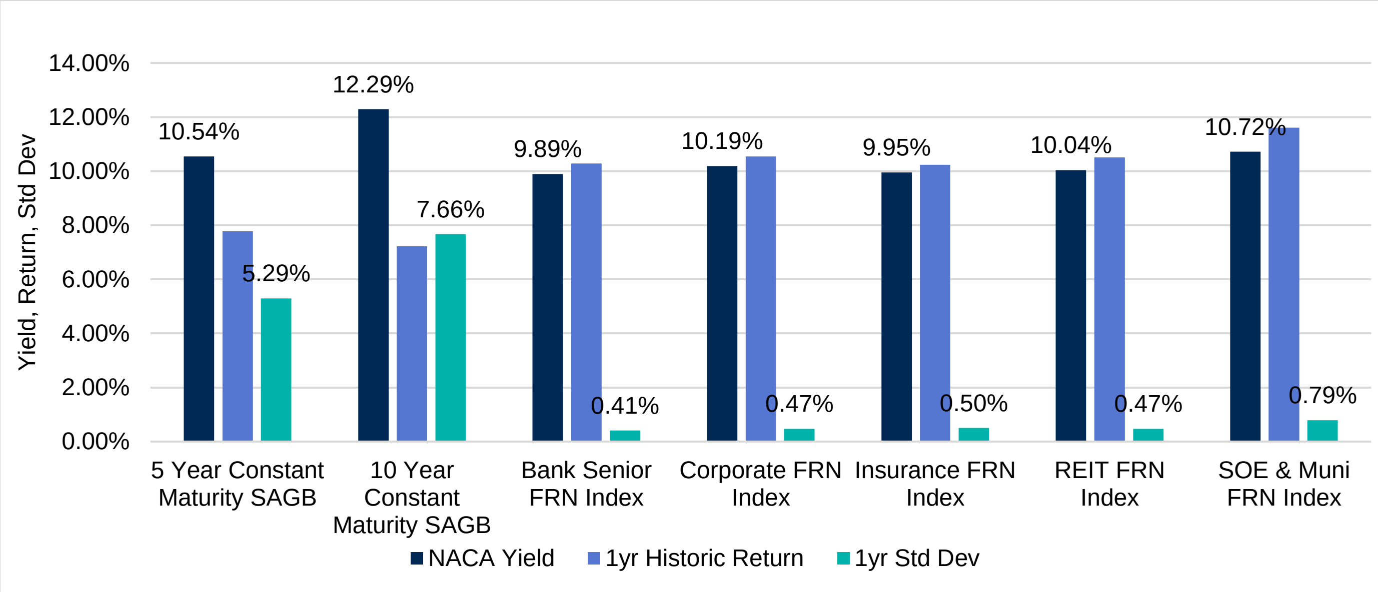
The question isn't "Why now?" but "Why not always?" Flexible income funds have consistently demonstrated their value across various market cycles, making them not just a temporary solution but a vital component of any diversified portfolio. Their adaptability sets them apart, with fund managers able to capitalise on market opportunities as and when they arise by adjusting asset allocation across their diversified portfolios.

For example, when appropriate, these funds can allocate a bigger proportion of assets under management to duration assets (either longer or shorter durations). They can invest in inflation-linked assets during inflationary periods, shift toward high-quality bonds during uncertain times, and increase exposure to higher-yielding credit instruments when interest rates are expected to decline. This dynamic investment approach not only ensures stable income generation but also minimises risk. Additionally, flexible income funds further enhance their return potential by including alternative income sources like preference shares and property.

While some investors express concerns about the volatility associated with duration and equity instruments and the perceived risks and complexity of credit instruments, these "risks" can be effectively mitigated within a well-diversified and carefully constructed portfolio. Interestingly, investors often tolerate significant equity market fluctuations but are wary of potential credit defaults despite market recoveries from credit events being potentially more favourable than a bounce-back in equities.

In a recent simple exercise to evaluate the value of corporate credit, we constructed various floating rate indices and compared these to constructed five-year and 10-year constant-maturity government bonds. We then overlaid the implied volatility of these indices to analyse the yields and demonstrate how the inclusion of these instruments affects portfolio volatility.

Figure 1: FI indices - Yield on offer and associated volatility

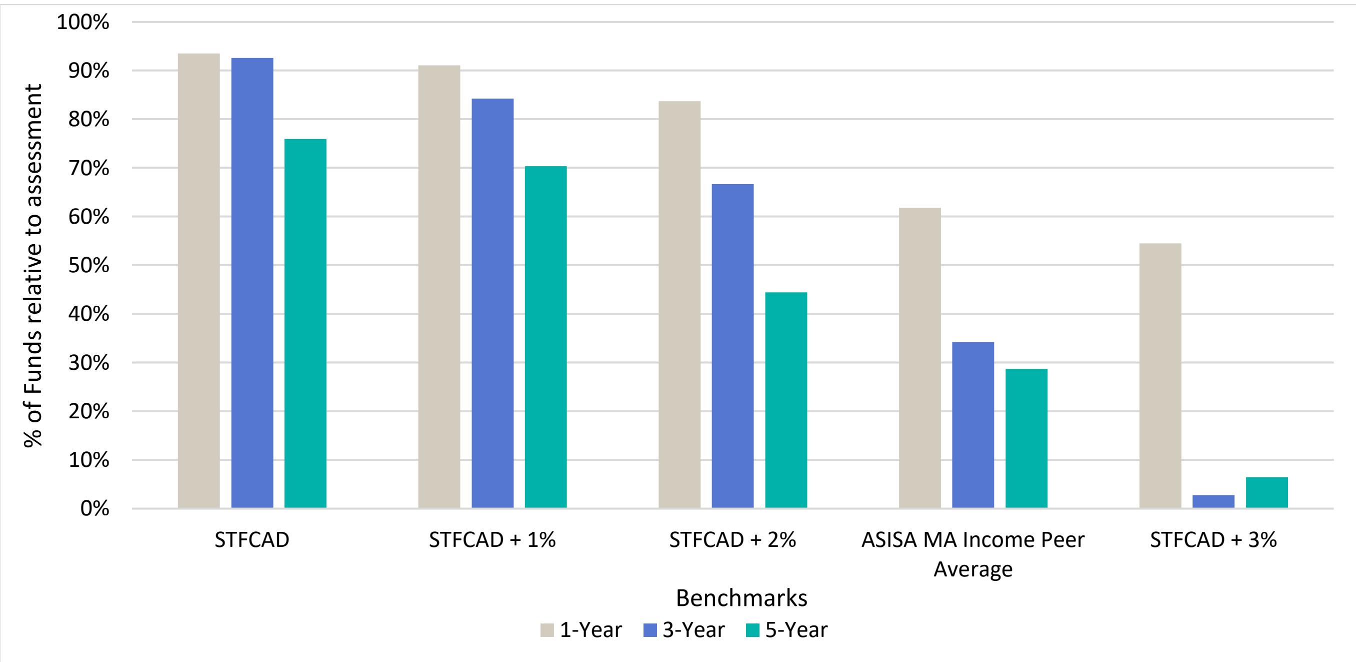



*Source: Prescient Investment Management, JSE Data (30 June 2024)*

The above graph details the enhanced returns potentially available from duration assets compared to corporate floaters. I t also clearly highlights the associated volatility of each category of instruments. It shows that credit instruments, with their diversifying characteristics and lower volatility, have a valuable role to play in well-constructed and diversified portfolios.

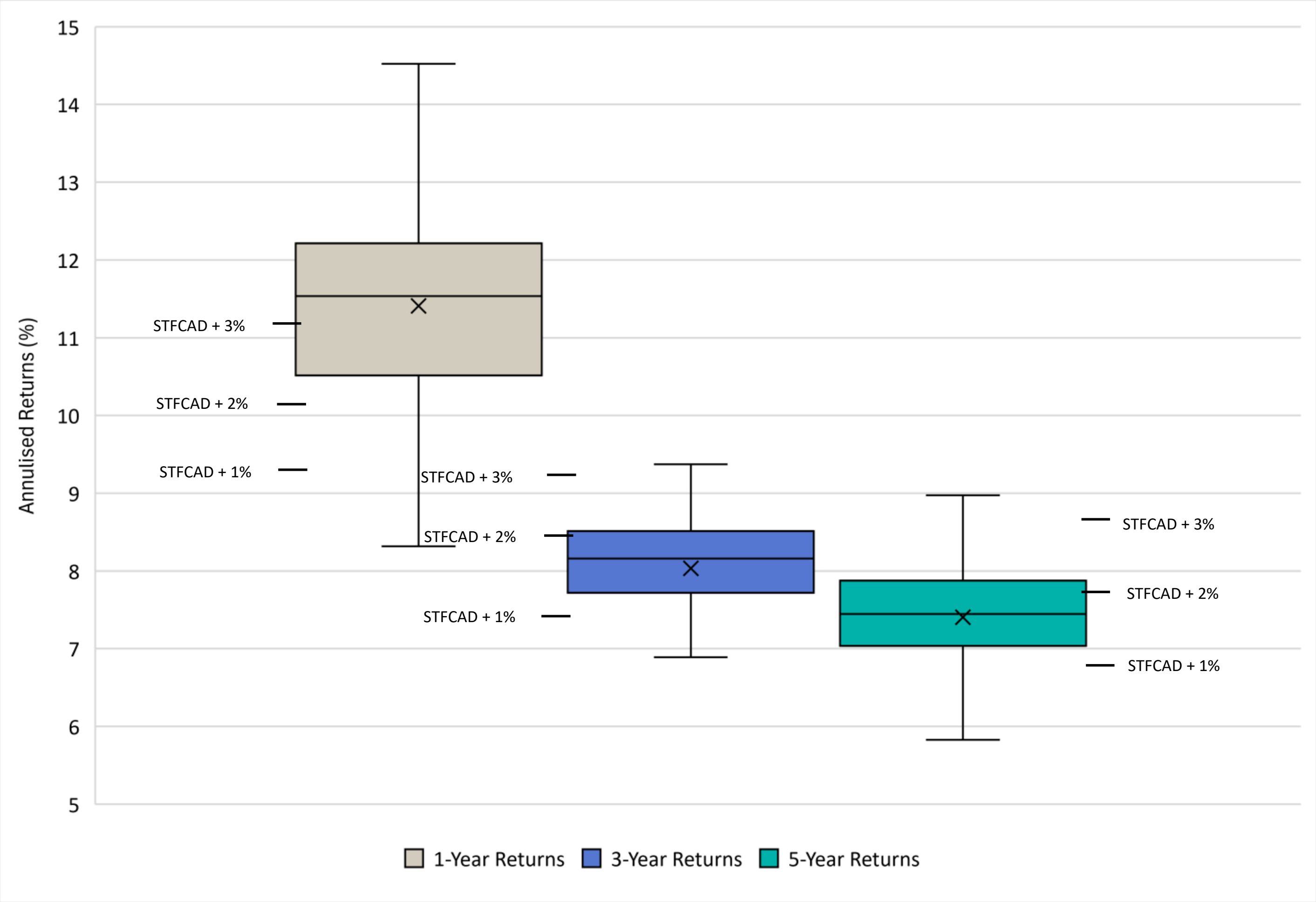
In Figure 2, we delve further into the value that income funds can bring to overall portfolios by quantifying the performance of income funds within the ASISA Multi-Asset Income category over one-, three- and five-year periods relative to the STeFI Call Deposit (STFCAD) + 1%/2%/3% and the category benchmark. Then, we measured the range of returns of funds within the category in Figure 3.

Figure 2: Performance stats for funds in the ASISA Multi-Asset Income category:



*Source: Funds on Friday, Prescient Investment Management, 19 August 2024*

Figure 3: Boxplot of Fund Returns in the ASISA Multi-Asset Income category:




*Source: Funds on Friday, Prescient Investment Management, 19 August 2024*

Figure 2 highlights the positive performance of the funds in the MA Income category relative to various benchmarks. Figure 3 further reinforces this, highlighting that, across all periods, median performance across income funds has surpassed the STFCAD + 1% figure.

We believe this success can be attributed to strategic asset allocation, thoughtful duration management, and a diverse range of instruments, including credit. It also highlights the level of risk management and portfolio construction process undertaken to achieve this success. Figure 1 displays the return enhancement benefits credit offers over cash by minimising the portfolio's volatility and allowing for better capital preservation.

These performance achievements support the view that the question isn't why flexible income funds are relevant now but why they deserve a permanent place in any well-considered investment strategy.

**Accessing Flexible Income Funds**

Investors looking to incorporate flexible income funds into their portfolios can do so via several channels:

- Financial Advisors: Investors can consult with financial advisors who can recommend suitable funds based on individual risk profiles and investment goals.
- Investment Platforms: Utilising online platforms offering flexible income funds, providing easy access and management options.
- Direct Investment: Investing directly with asset management companies that manage flexible income funds, offering direct exposure to their performance.

In today's complex investment environment, it is essential to explore all available options that allow investors to meet their objectives, whether it's stability, return and growth potential, or simply the funds available to them. By incorporating various tools

into a diversified portfolio, investors can navigate the complexities of the market, achieve their wealth protection or growth financial objectives and potentially enhance their overall returns.
Within this context, flexible income funds have proved to be a convincing alternative to money market funds.

**Disclaimer:**