PRUDENTIAL BALANCED FUND
30 JUNE 2017

PRUDENTIAL
INVESTMENT MANAGERS

QUARTERLY COMMENTARY

MULTI-ASSET

PERFORMANCE

The fund returned -1.8% for the quarter ending 30 June 2017 (net of fees), in line with its benchmark, the average of the ASISA Multi-Asset High Equity category. Over one year the fund's 4.1% return has outperformed the 1.5% from the benchmark, and over five years it has outperformed with 12.6% p.a. versus the benchmark's 9.8% p.a. The main contributors to performance were the fund's holdings of international equity and listed property, and to a lesser extent, South African listed property, bonds and cash. The main detractor was its exposure to South African equity, where the local market posted losses for the period.

MARKET OVERVIEW

Global growth maintained a steady pace in the second quarter of 2017 (Q2), making it another positive period for global investors as unemployment rates fell and trade accelerated. In contrast, in South Africa investment returns were hit by worsening investor sentiment following the June credit rating downgrades and a second quarter of negative GDP growth, as well as rising political uncertainty caused by widening government corruption scandals and policy disagreements. Keen foreign investor demand for high-yielding SA bonds drove solid returns in those assets, as well as contributing to rand appreciation for the quarter.

US markets were stronger during the quarter although the Trump "reflation" trend lost some steam in June. The S&P 500 and Dow Jones reached fresh record highs as US corporate earnings continued to grow, but worries grew over high valuations, and tech stocks experienced a sell-off in June amid fears of a bubble. For Q2, the S&P 500 returned 3.1% and the Nasdaq 4.2% (but -2.4% in June). As widely expected, the US Federal Reserve hiked interest rates by 25bps at its June FOMC meeting, and continued to signal one further 25bp rate hike in 2017 and three more hikes for 2018. This is little changed from its (and the market's) previous forecasts, with the market pricing in a 40% chance of a hike in December, and only 20% in September.

The Barclays Global Aggregate Bond Index (US$), a mixture of government and corporate bonds, returned 2.6% in the quarter. US Treasuries returned 1.2%, while investment-grade corporate bond spreads narrowed slightly to 112bps over USTs from 120bps at the beginning of the quarter, and high-yield spreads widened to 408bps from 391bps previously.

In the Eurozone, the French elections were the latest to sweep away populist fears and the region's Q2 GDP growth came in mostly steady at 1.7% (q/q annualised), the latest data confirming a continuing recovery. The Dow Jones Eurostoxx 50 returned 6.5% in US$. The UK, meanwhile, saw a disastrous snap-election outcome for PM Theresa May as her Conservative party lost its Parliamentary majority. Amid Brexit uncertainty, UK growth eased somewhat and sterling continued to weaken. The FTSE 100 returned 4.7% (in US$) over the quarter, but -1.5% in June. The Nikkei 225 Index returned 5.2% over the quarter (in US$). China's good start to the year continued in Q2 as Q1 GDP growth surprised to the upside at 6.9% (q/q annualised). Many analysts do expect a slowdown later in the year as the effects of government stimulus fade.

Emerging market assets recorded good gains in Q2 amid continuing investor demand for risk assets. The MSCI Emerging Markets Index returned 6.3% in US$, compared to 4.0% from the MSCI World Index for developed markets. Among the larger EM equity markets in US$ terms, the MSCI Turkey was by far the strongest performer with a 19.8% total return, followed by the MSCI China with 10.7% and South Korea's KOSPI (8.6%). The poorest Q2 returns (in US$) came from the MSCI Russia (-9.8%) and Brazil's Bovespa (-7.3%). The MSCI South Africa returned 3.6% in US$.

South Africa moved closer to "full" sub-investment grade status in June following Moody's downgrade from Baa2 to Baa3, with a negative outlook indicating that a further cut – to sub-investment grade level – is likely. The economy also unexpectedly moved into a technical recession with Q1 GDP growth of -0.7% (following -0.3% in Q4 2016). Some good news emerged when both S&P Global and Fitch refrained from further downgrades, although these foreign currency ratings are already in sub-investment grade territory.

At the SA Reserve Bank's Monetary Policy Committee (MPC) 25 May meeting the MPC left the repo rate unchanged at 7.0%, citing lower inflation (May inflation was 5.4% y/y) and weaker growth and inflation prospects. While suggesting strongly that the rate hiking cycle was at an end, the Governor also cautioned that a cut was unlikely in the near term. Nevertheless, markets are pricing in an increasing likelihood of at least a 25bp rate cut later this year.

Attracted by South Africa's relatively high bond yields following the April downgrades, foreign investors were keen buyers of local bonds during Q2, which helped drive positive returns as well as rand strength in the three months. The BEASSA All Bond Index returned 1.5% in Q2 and 4.0% for the year to date. Inflation-linked bonds (ILB Composite Index) returned 1.0% in the quarter, and cash (the STeFI Composite) returned 1.9%.The rand, meanwhile, continued its appreciation versus the US dollar, gaining 2.6%, while it lost 4.3% against the euro and 1.0% versus the UK pound.

The FTSE/JSE All Share Index returned -0.4% for Q2 (and 3.4% year to date), dragged lower by a confluence of factors. With a return of -7.0%, Resources shares were the worst performers due to the fall in commodity prices. Industrial shares delivered 2.2%, helped by strong gains in Naspers, while Financials were flat at 0.0%, dented by the downgrades. Listed property, meanwhile, returned 0.9%, underpinned partly by falling inflation and an improved interest rate outlook.

STRATEGY AND OUTLOOK

In global fixed income, government bond yields continue to be expensive given the very low levels at which they are trading from an historic perspective. They are also at risk to rising interest rates in the US, and increasingly in Europe as well. We remain underweight sovereign bonds and underweight duration, and continue to hold cash and shorter-term bonds in order to reduce interest rate risk. The fund continues to hold corporate bonds (largely investment-grade US and European credit) where we see value, and some emerging market government bonds (most notably, Mexican).

For global equities, despite strong market performance over the past 12 months or so, many regions remain attractively valued, particularly given the fundamental backdrop of broad global macroeconomic improvement, with strong economic indicators feeding through to company earnings. As such, the fund is overweight global equities. We have a preference for certain markets where we see good value and fundamentals remain encouraging, including Europe, Japan, Korea, Turkey and Indonesia, as well as the global financial sector, compared to global indices and the broad US market.

South African equity valuations improved marginally over the quarter to become slightly cheaper versus their long-term fair value, as future corporate earnings growth estimates increased slightly and equity prices declined slightly. The FTSE/JSE ALSI 12-month forward P/E fell to 13.9x at quarter-end from 14.1x in Q1 2016. The fund is broadly neutrally positioned based on these valuations.

The fund is overweight global stocks like British American Tobacco, Anglo American, Exxaro and Sasol. We also hold non-mining global stocks like Naspers and Sappi. We remain overweight in well-priced and high-yielding Financials including Old Mutual, Investec, Standard Bank and Barclays Group Africa. We maintained our underweight in Retail stocks given the challenging consumer environment, but do continue to hold selective overweights in Foschini and Pick 'n Pay. We have preferred to gain our consumer exposure via well-priced and more defensive consumer services providers like Sun International.

In SA listed property, we retained our overweight exposure in the fund during the quarter, with valuations at around long-term fair value. At quarter-end, listed property companies (excluding developers) were priced to return around 16% p.a. over the medium-term (assuming no change in the market's rating/valuation of property), comfortably above inflation and, we believe, ample compensation for the risk involved. Even with the market pricing in a de-rating of around 4%, somewhat higher than Q1, the medium-term prospective return would be approximately 12% p.a.

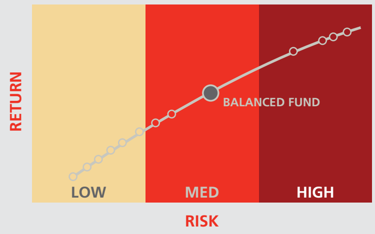
In SA nominal bonds, the fund is overweight as valuations remain on the cheap side of fair value. Within this exposure, we prefer longer-dated bonds versus shorter paper due to the more attractive yields on offer, while retaining our overweight exposure to corporate bonds. The fund remains underweight inflation-linked bonds and SA cash. ■

ANNUALISED PERFORMANCE	A CLASS	BENCHMARK	T CLASS	X CLASS	B CLASS
1 year	4.1%	1.5%	4.6%	4.3%	4.9%
3 years	6.4%	4.7%	n/a	6.7%	7.2%
5 years	12.6%	9.8%	n/a	n/a	13.4%
7 years	13.1%	10.1%	n/a	n/a	14.1%
10 years	9.7%	7.8%	n/a	n/a	10.7%
Since inception	14.1%	12.2%	5.2%	11.1%	14.5%

Inception dates: X Class: 2 January 2013, B Class: 1 July 2002, T Class: 2 January 2015

ASSET CLASS RETURNS	Q2 2017	YTD
SA Equity (FTSE/JSE All Share Index)	-0.4%	3.4%
SA Property (FTSE/JSE SA Listed property Index)	0.9%	2.3%
SA Bonds (BEASSA All Bond Index)	1.5%	4.0%
SA Inflation-linked Bonds (RSA Composite Inflation-linked Bond Index)	1.0%	0.4%
SA Cash (STeFI Composite)	1.9%	3.7%
Global Equity (MSCI World Index - USD)	4.0%	10.7%
Global Equity (MSCI Emerging Markets Index – USD)	6.3%	18.4%
Global Bonds (Barclays Global Aggregate Bond Index – USD)	2.6%	14.4%
Rand (Rand/USD move)	-2.3%	-4.4%

RISK/RETURN PROFILE:



FUND MANAGERS:

David Knee, Duncan Schwulst, Michael Moyle and Johny Lambridis

ASISA CATEGORY:

South African - Multi-Asset - High Equity

BENCHMARK:

ASISA South African - Multi-Asset - High Equity Category Average

INCEPTION DATE:

2 August 1999

FUND SIZE:

R15 888 605 887

Sources: Prudential, Morningstar & Deutsche Securities