MERGENCE
INVESTMENT MANAGERS

Macro and Multi-Asset

November 2022

Strategic asset allocation provides a long-term focus for the portfolios we manage at Mergence Investment Managers. Each year we review our strategic asset allocation and update our long-term assumptions of risks and returns to include new information from markets, policymakers, and regulators. This year our work was motivated by changes in the investment environment in South Africa, as well global investment trends we expect to see over the next 10 to 15 years.

This report highlights some of the work that we undertook in this process and summarises the changes we have made to our strategic asset allocation across the range of multi-asset funds we manage.

Current Views

UNDERWEIGHT	OVERWEIGHT	OVERWEIGHT	OVERWEIGHT	OVERWEIGHT
Risk Assets	South African equity vs Global equity	South African Fixed Income	Global credit vs equity	USD Cash

Asset Allocation Views

Asset Class	Valuation based 3-Year Forecast Return	Underweight	Neutral	Overweight
SA Equity	18%		Neutral	
SA Property	17%		Neutral	
SA Fixed Bonds	10%			Overweight
SA Inflation-Linked Bonds	5%		Neutral	
Emerging Market Equity	8%	Underweight		
Developed Market Equity	3%	Underweight		
Global Property	10%	Underweight		
Emerging Market Sovereign. Bonds	7%		Neutral	
Developed Market Sovereign. Bonds	1%			Overweight
Global Corporate Bonds	3%		Neutral	
Global Inflation-Linked Bonds	2%	Underweight		
Global High-Yield Bonds	6%		Neutral	
Offshore Cash	1%			Overweight

Source: Mergence Calculation. All forecasts in ZAR. Current asset allocation views are relative to our Strategic Asset Allocation.

Update to our Strategic Asset Allocation

At Mergence Investment Managers, Strategic Asset Allocation (SAA) forms the foundation for designing multi-asset solutions that meet the needs of our clients. Each year we enhance our SAA by incorporating quantitative and qualitative insights from across the team. Our aim is to improve the resilience of the portfolios we manage by setting reasonable expectations or risks and returns of asset classes over the next 10- to 15-year time horizon. We highlight the changes made after our recent 2022 review of our SAA below.

Overview of Changes

We improved the diversification of our portfolios by expanding our asset class universe set. We added an SA money market asset class and expanded our global bonds coverage universe this year to include emerging markets government bonds, developed markets government bonds, and global corporate bonds.

We refreshed our long-term capital market assumptions i.e., our expectations of risks and returns over a 10- to 15-year time frame. In determining our capital market assumptions, we considered the risk of each asset class within the context of how future economic conditions may differ from those in the past. Our capital market assumptions are covered in the section below.

We expect global inflation to be higher over the next decade compared to the recent past. While global inflation rates are currently high, for example, the annual inflation rate was 7.7% in the US and 7.6% in South Africa in October of 2022, we expect inflation to moderate over the next few years. As a result, we modestly raised our long-term US inflation forecast by 0.25%, to 2.25%, and reduced our expected US-South Africa inflation differential by 0.5% to 3.5%.

Globally we expect real rates over the next decade to be higher compared to the recent past. With the rapid unwinding of negative policy rates across markets, we expect higher yields and improved opportunities from global bonds. We have increased our expected returns for global bonds, global inflation-linked bonds, and global high-yield bonds. Though historically the correlations between bonds and equities have turned positive over periods of high inflation, over a longer time horizon we expect inflation to moderate, and for bonds to again offer improved diversification benefits.

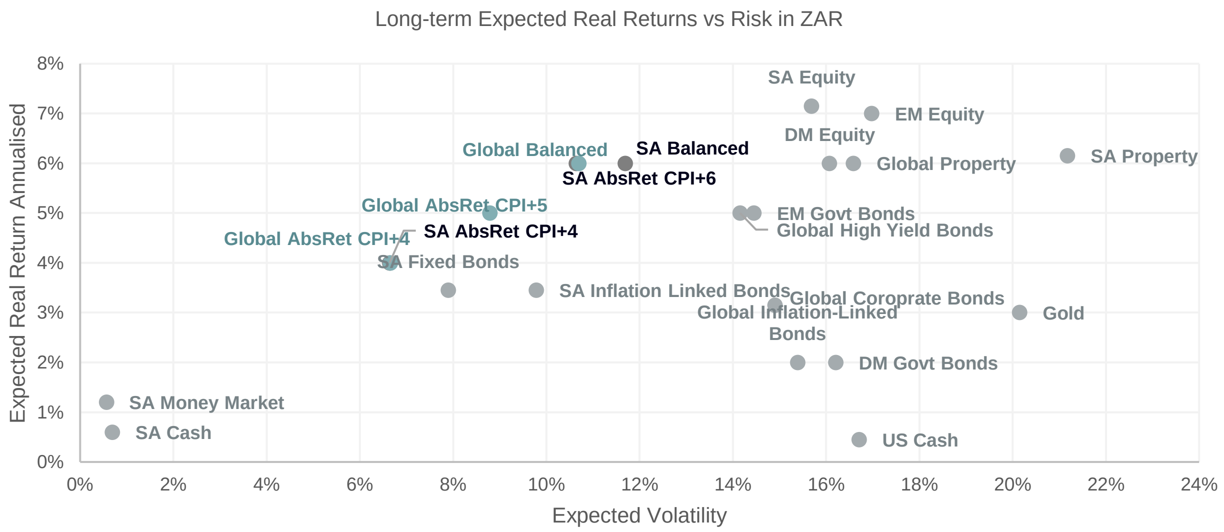
In South Africa, the maximum limit of offshore allocation in Regulation 28 funds changed from 30% to 45%. We therefore changed our asset class constraints by increasing the maximum offshore investment limit in our models to 45%. We also raised our allocation to offshore assets in our global balanced and global absolute return funds. This change has broadened investment opportunities and improved the diversification of our global solutions.

We reduced model-specific risks by running iterations of mean-variance optimisation that include multiple objective functions for our funds. These include maximising risk-adjusted returns, minimising downside risks, and maximising the probability of meeting our real return targets over time. Taking a multiple objective function testing approach to mean-variance optimisation has helped us improve the resilience of our solutions.

While mean-variance optimisation is widely used, both academics and practitioners agree that the analysis is sensitive to errors in input assumptions. We therefore mitigated risks to our assumptions by running scenarios that change our base case assumptions. Additionally, we stress-tested our solutions, focusing on periods of high asset class correlations.

Overall, we believe that the long-term outlook for growth assets remains stable. While 2022 highlighted the importance of portfolio diversification, it has also provided meaningful corrections for risk assets. Due to the improved diversification of our solutions, and the benefits of attractive starting points, we were able to moderately increase our long-term strategic allocation to growth assets in our absolute return and balanced funds, especially in funds with higher real return targets.

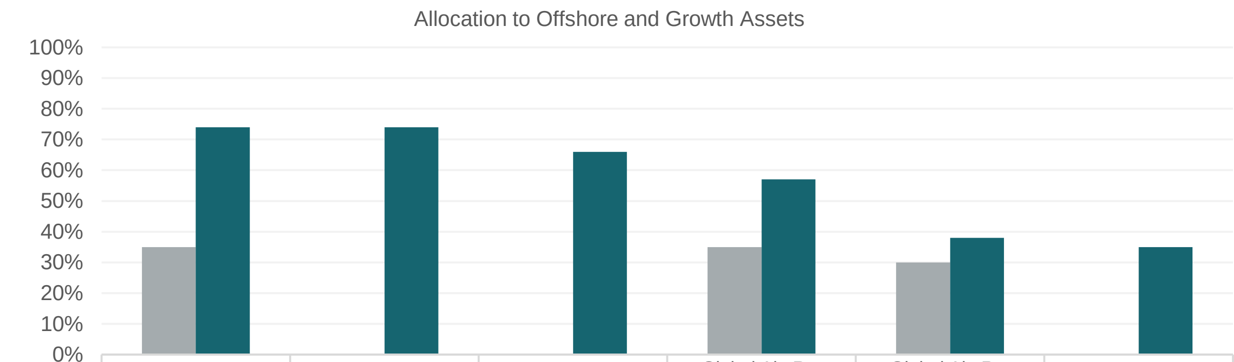
Capital Market Assumptions



Note that while the long-term expected risk and return profile for our absolute return and balanced mandates looks similar in the chart above, their asset allocation mixes differ as we have created and tested our absolute return solutions to minimise downside risk.

Allocation to Offshore and Growth Assets

The charts below summarises the SAA of our global and SA Regulation 28 solutions, where we moderately increased our allocations to growth assets and increased our allocation to offshore assets, where relevant. In all solutions, the SAA- to Offshore assets is below the 45% regulatory maximum, with the largest strategic offshore allocation at 35% in our global balanced and global CPI + 5 % solutions. This allows us some flexibility to tactically increase the fund's offshore allocation up to the regulatory limit when our tactical asset allocation views requires, something that would not have been possible at the previous regulatory limit on offshore exposure.

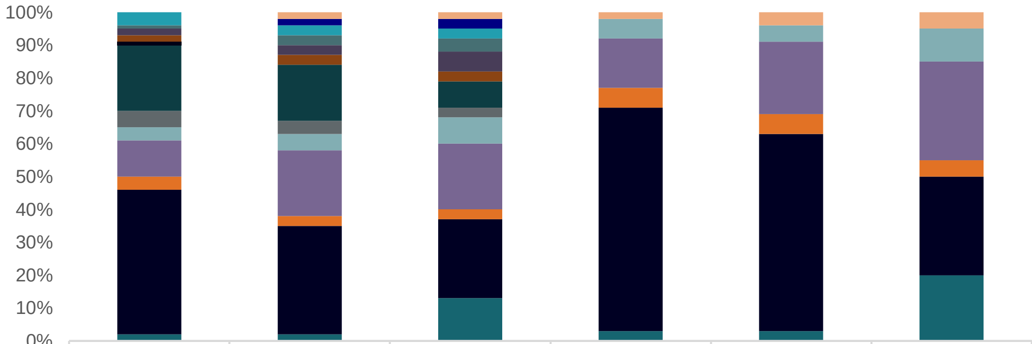


	Global Balanced	SA Balanced	SA AbsRet CPI+6	Global AbsRet CPI+5	Global AbsRet CPI+4	SA Abs Ret CPI+4
Offshore	35%	0%	0%	35%	30%	0%
Growth	74%	74%	66%	57%	38%	35%

SAA solutions

The chart below summarises the updated SAAs across the multiasset mandates that we currently manage. We believe that these solutions provide a well diversified asset allocation targeting the correct risk for each mandate and a solid starting point for our multi-asset portfolio construction. This increase in breadth of our asset class universe that we have achieved with this SAA update not only improves the diversification of the strategic portfolios below, but also the breath of opportunities for our process to add value through tactical asset allocation and security selection.

Strategic Asset Allocation



	Global Balanced	Global AbsRet CPI+5	Global AbsRet CPI+4	SA Balanced	SA AbsRet CPI+6	SA AbsRet CPI+4
Gold	0%	2%	2%	2%	4%	5%
US Cash	0%	2%	3%	0%	0%	0%
Global High Yield Bonds	4%	3%	3%	0%	0%	0%
Global Inflation-Linked Bonds	0%	0%	0%	0%	0%	0%
Global Corporate Bonds	1%	3%	4%	0%	0%	0%
DM Govt Bonds	2%	3%	6%	0%	0%	0%
EM Govt Bonds	2%	3%	3%	0%	0%	0%
Global Property	1%	0%	0%	0%	0%	0%
DM Equity	20%	17%	8%	0%	0%	0%
EM Equity	5%	4%	3%	0%	0%	0%
SA Inflation Linked Bonds	4%	5%	8%	6%	5%	10%
SA Fixed Bonds	11%	20%	20%	15%	22%	30%
SA Property	4%	3%	3%	6%	6%	5%
SA Equity	44%	33%	24%	68%	60%	30%
SA Money Market	2%	2%	13%	3%	3%	20%
SA Cash	0%	0%	0%	0%	0%	0%

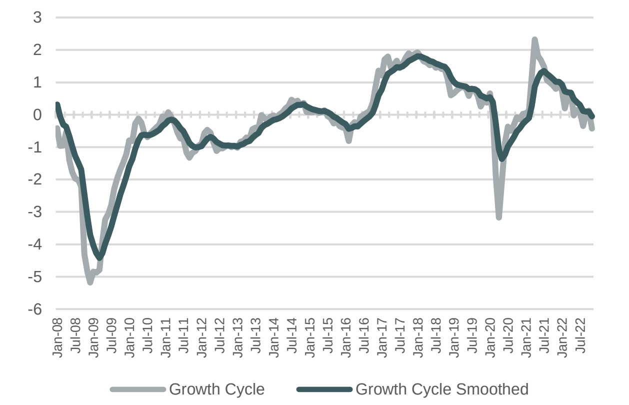
Macro and Multi-Asset

Key Indicator Forecasts

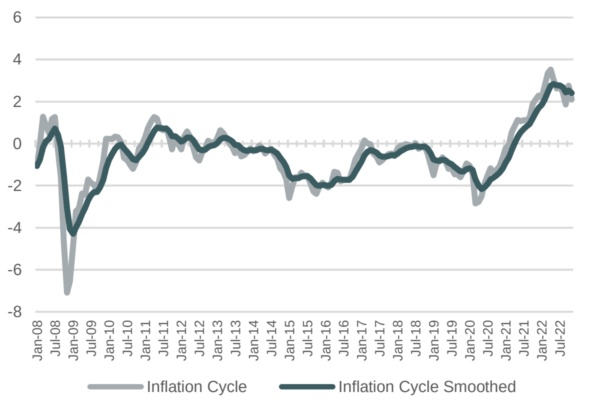
Indicator	Current	1 Year	3 Year	5 Year
USDZAR	17.1	14.9	15.7	16.5
EURZAR	17.9	17.4	18.5	19.7
GBPZAR	20.7	20.0	21.0	22.1
SA 10 Year Yield	10.2%	10.3%	9.0%	9.0%
US 10 Year Yield	3.7%	3.6%	3.0%	3.0%
SA Inflation	7.6%	4.8%	4.9%	5.0%
US Inflation	7.7%	3.3%	2.4%	2.5%
SA Repo Rate	7.0%	6.8%	7.0%	7.0%
US Fed Funds Rate	3.8%	4.6%	3.0%	2.5%

Key Macro Charts

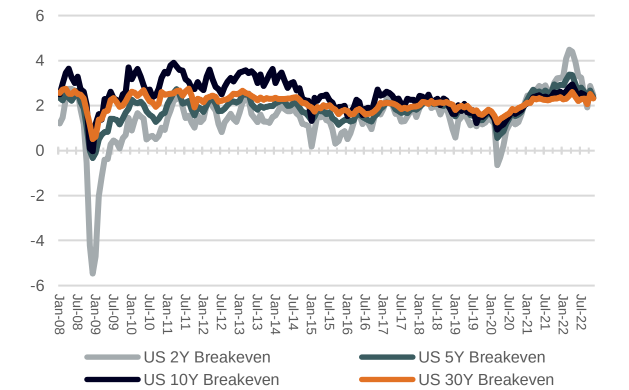
Mergence Growth Cycle



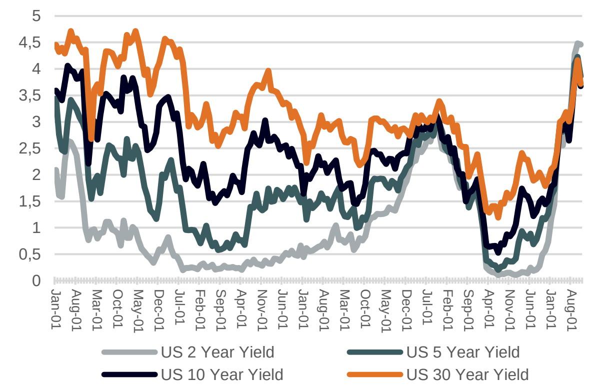
Mergence Inflation Cycle



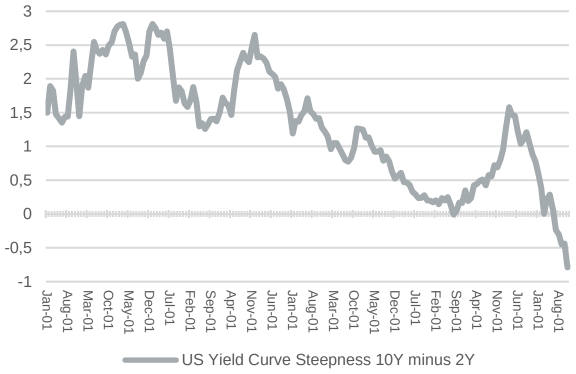
US breakeven rates



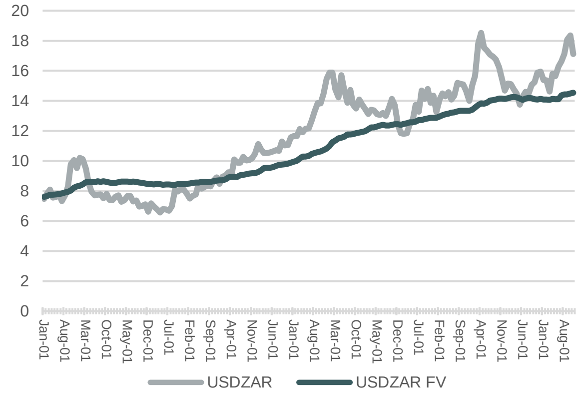
US bond yields



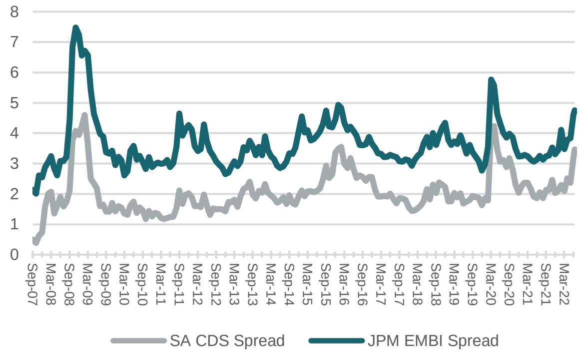
US yield curve



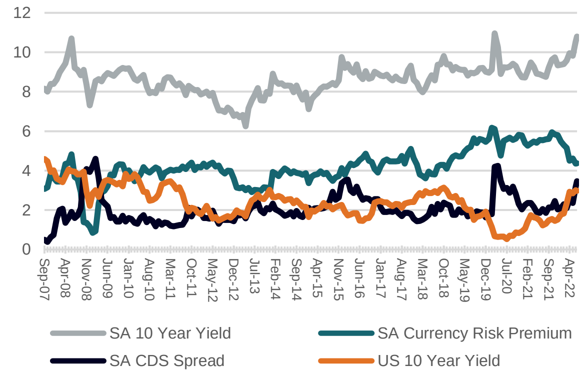
USDZAR



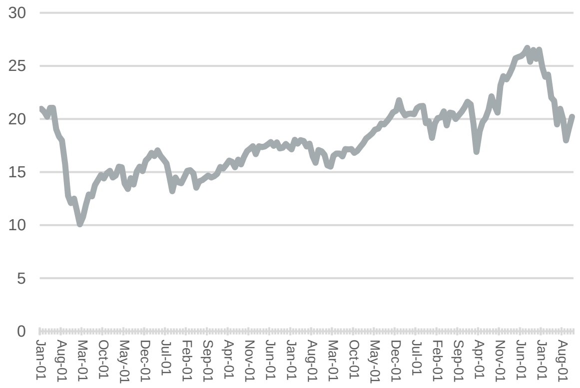
SA CDS



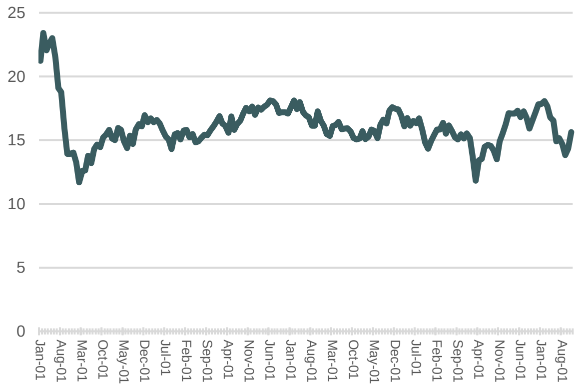
SA YIELD BREAKDOWN



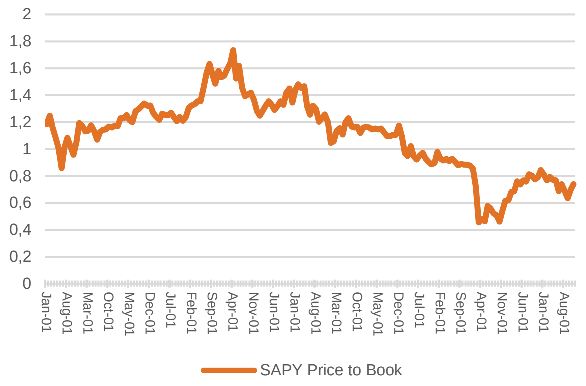
MSCI World CAPE



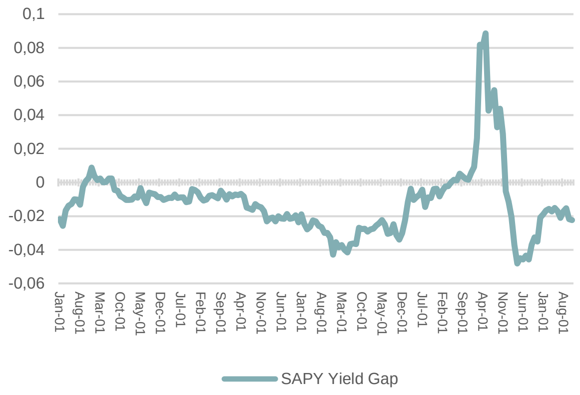
JSE All Share CAPE



SAPY price to book



SAPY yield gap



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