PRESS RELEASE

The advantage of ILBs in a money market fund

In the world of low interest rates, Inflation Linked Bonds offer a compelling proposition for money market funds, says Volantis Capital's Rhandzo Mukansi

The millions of articles written about the impact of Covid-19 can't begin to do justice to the damage wrought to individuals, society, and the economy. But financially speaking, the damage could have been worse. In a commendable act of foresight, global central banks aggressively eased monetary conditions by slashing lending rates, and bolstered market liquidity to ensure the smooth functioning of financial markets. Accordingly, the South African Reserve Bank (SARB) cut the central interest rate by a cumulative 3 percentage pointsin 2020– from 6.50% to 3.50%.

While positive formacroeconomic growth, this has naturally had the effect of diminishing the returns on cash and cash equivalent products. This is illustrated by the suppressed STeFI Composite Index return of 5.39% in 2020 – compared to the 7.29% it returned in 2019. This presents the challenge to fund managers of how to achieve alpha in an era of low and exceptionally flat money market curves. Against this backdrop, an off-benchmark allocation to short-dated inflation linked bonds (ILBs) has proved a compelling investment opportunity for our money market fund.

Relative to the 3.52% 3-month JIBAR rate at the point of trade entry, the RSA issued R212 ILB offered an expected total return of 5.2%.This equates to nearly a 2%spread over the 3-month JIBAR. This expected return not only compares well to a term matched NCD or Treasury Bills, but also to senior floating-rate bank credit with their longer term to maturity.

The value proposition of South Africa's sovereignexposure is largely a function of a strained fiscal position. This is evident in the steeply sloped term structure of domestic interest rates, and the real yields on offer as a result. Unlike long-dated sovereign exposure, the expected return of the R212 over its remaining life is largely inflation-carry related – and therefore does not attract the excess duration risk associated with long-dated sovereign exposure.

At Volantis Capital, our asset allocation to short-dated ILBs in our money market fund, combined with our specialist credit capability, has allowed us to enhance the utility of our ILB exposure. Playing on the liquidity constraints in the domestic ILB market, credit linked ILB exposure often offers large illiquidity premiums that serve to boost real returns offered by the asset class. We manage this risk by limiting our ILB exposure to short-dated instruments as well asappropriately managing the size of the allocation to ensure that fund liquidity is not compromised.

The management of our off-benchmark ILB exposure in our money market fund is a good exampleof our two primary investment competencies at work: credit and interest rate management. Against a backdrop of low money market yields, we continue to exploit our knowledge of the domestic interest-bearing market for enhanced fund performance.

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About the Author:

Rhandzo Mukansi is the Head of Portfolio Management at Volantis Capital. He has an 8-year asset management track record, with specialization in interest rate analysis and fixed income portfolio management.