ETF Note: RMB Inflation X

JSE Code: BIPINF	**Tracks:** GILBx Index	**Last updated:** June 2010
Issuer: RMB	**Risk level:** low, bonds	**Performance YTD:** 1.90%

Characteristics:

The aim of this ETF is to give the investor direct exposure to an index that tracks the performance of Government inflation-linked Bonds. The purpose of doing this is to guarantee investors a real return, ie one which prevents the erosion of capital by inflation because it ensures the interest rate is pegged to the Consumer Price Index. In this way the interest that you earn from holding the ETF will always be higher than the inflation rate over the medium term. The 4 Rand denominated bonds that make up the index are all issued by the South African Government and trade on the Bond Exchange of South Africa (BESA) – and despite what is happening in Europe – the SA Government remains a good debtor and therefore the bonds are deemed to be free of credit risk.

When buying this ETF you are essentially lending money to the government, and consequently the interest that you are entitled to is disbursed quarterly at the end of March, June, September and December. The current real yield is 2.79%.

Mechanics and outlook

The concept of this ETF is very simple: to provide investors with a real return – ie one that beats inflation – by pegging the return you receive to CPI (+ a real retun of 2.79%), which is the most widely used way of measuring inflation in the country. Statistics South Africa (StatsSA) is responsible for measuring CPI – which is compiled and reported monthly.

The process is fairly straightforward – StatsSA takes a basket of goods that they believe represents what most people buy on a monthly basis – things like food and beverages, as well as electricity and water, healthcare, transportation, communication and recreation expenses and then measures the price change from month-to-month. By weighting the different parts of the basket based on what they think makes up the largest portion of spending (the cost of housing is the biggest expense for most people so it gets allocated a bigger weighting than cigarettes for example) they come to a figure which is widely reported in the media as the average rate at which

What the bulls say:

- Gives exposure to a portfolio of Government Bonds that will yield a return higher than inflation – as measured by the Consumer Price Index (CPI) over the medium term.
- Can be accessed through a cost effective investment scheme (savings plan).
- TER is expected to be lowered to 0.39% in the near future.

What the bears say:

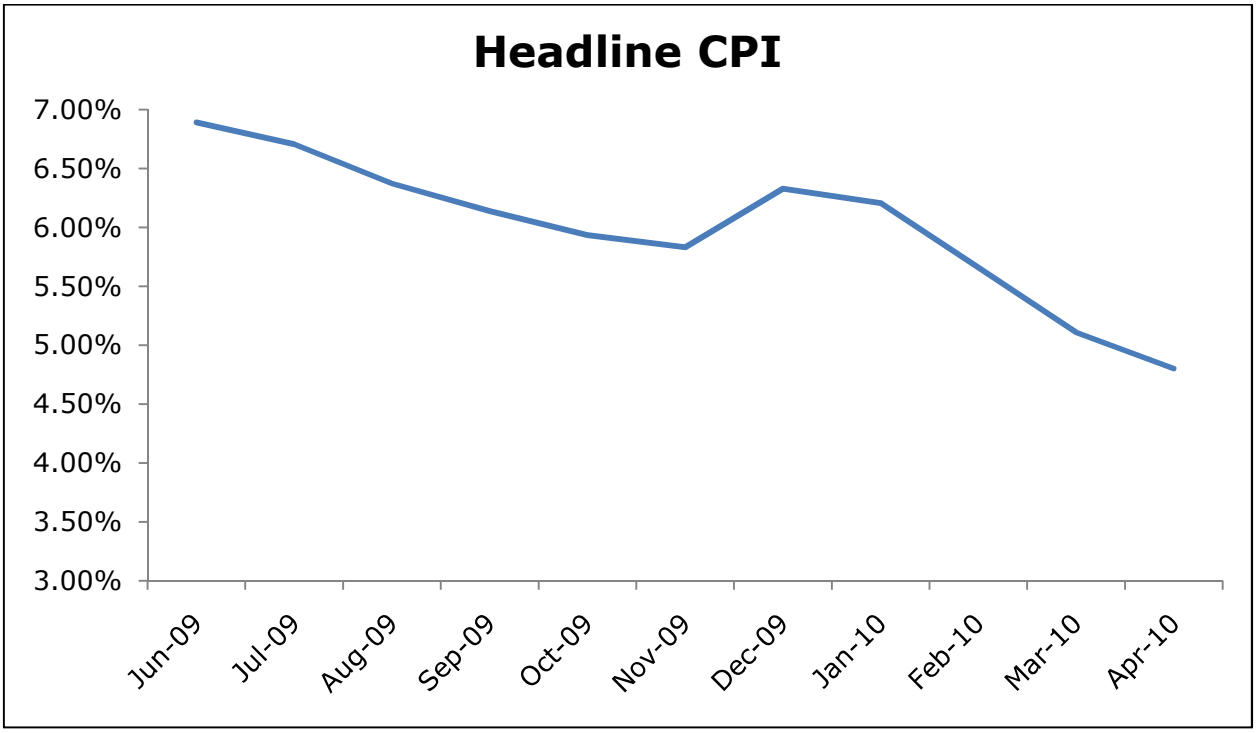
- In the current benign interest rate environment the yield on this instrument should be cash but fall lower than returns on other Government bond portfolios.
- The Reserve Bank aims to keep inflation in a 3-6% bracket.

prices are increasing. The Reserve Bank in turn keeps a very beady eye on inflation, as its mandate is to keep inflation between its 3-6% range. When inflation moves out of the upward limit of this bracket (yes – above 6%) then the Reserve Bank Governor will begin raising interest rates to curb spending and keep inflation under control.

The return which you will receive is calculated as follows:

CPI (as measured monthly by Stats SA) + 2.79%* (the real return) – 0.47% (TER)

= CPI + 2.32%. This is the annual return, but as interest is paid quarterly you will divide this number by 4 to see what you get paid every three months. *The real return is a variable rate and will be locked in at the time of investing.



Source: I-net Bridge

As can be seen from the above graph, inflation has been on a downward trend following the Financial crisis. Aiding and abetting the situation, has been the strong performance of the Rand, as well as a collapse in the price of oil (although recently this has changed). With most sectors of the economy struggling through the tough times, the inflationary pressure caused by economic growth has also been restrained. This has allowed the Reserve Bank to cuts rates, with perhaps one more still in store this year. What this means for investors looking to put money into this instrument, is that by following the calculation we outlined above, yields on the Inflation X are expected to be in the region of 6 - 6.5% for the foreseeable future.

Portfolio construction:

Investors looking for a conservative regular income distribution and a hedge against inflation would buy this ETF. It has a very low risk rating, as you are essentially betting that the national Government of South Africa will repay your interest and capital. This instrument is susceptible

to capital gains and losses because as expectations of inflation change, so too will the price and yield of the underlying bonds.

Investors can now combine the various ETFs available locally to create their own balanced fund and diversify their investments across asset classes. A general rule of thumb is that you subtract your age from 100 to determine how much of your money should be invested in equities. The balance should be in cash and bonds. For instance, if you are 30 years old, you would invest 70% of your portfolio in stocks using something like the BIPS 40 which tracks 40 of the largest companies on the JSE, so 30% would be invested in bonds and cash. Conversely if you are 70 years old you would have 70% of your portfolio in cash and bonds and 30% in equities. This is a basic rule of thumb and we encourage you to use an independent financial advisor to assist you in making these decisions.

For the portion of your money that needs to be invested in bonds, you would use this product (especially when the yield surpasses the interest rate available at your bank) in combination with the Investec ZGovi ETF.

The instrument can be bought directly on the JSE through your stockbroker which only makes sense for amounts > R10,000 as brokerage fees make this prohibitively expensive, or it can be purchased monthly in small or large amounts through an investment plan operated by the likes of ETFSA or AOS (who run it on behalf of the issuer, RMB).

Fees and alternatives:

The Total Expense Ratio (TER) for the ETF is currently 0.47%, however we understand that this is set to drop to <0.40% for amounts < R30m, in the very near future.

This ETF is the only one of its kind that tracks Government inflation-protected bonds. The nearest substitute would of course be to go and buy the bonds yourself on BESA. You would need a minimum of R1m per bond in order to do this. The other ETF that gives exposure to government debt is the Investec ZGovi, which tracks the BESA Government Bond index. The current interest yield there is 8.10% with a TER of 0.34% . Now in theory, bond yields will move with changes in the expectation of future interest rates – so if inflation misbehaves and it's likely the Reserve Bank will adjust interest rates upwards, then bond yields should start to rise as well. But this is not always the case and for that reason I see the ZGovi and Inflation X as complementary. In environments where inflation is high the Inflation X will be a far superior product in terms of the yield investors will enjoy.

The research analyst who prepared this report certifies that the view expressed herein accurately reflect the research analyst's personal views about the subject security and issuer and that no part of his compensation was, is or will be directly or indirectly related to specific recommendations or views contained in this report.