

WHAT THE BIG INVESTMENT MANAGERS THINK ABOUT THE FUTURE : *INVESTEC, STANLIB, OLD MUTUAL*

What do you see as the biggest known risks to investors currently?

Chris Freund : Investec

In an environment of heightened political and economic uncertainty, the risks to investors are manifold. The large swings in market sentiment and equity market performance have highlighted the volatile world we face, and we believe this market volatility will remain in the near term. On top of these uncertain global market conditions, South Africa also faces economic and political uncertainty.

We question how central banks are going to extricate themselves from their current extraordinary monetary policy, which is not having the desired outcomes. We are also cautious about China, given that many of the banks there are bust. While the plan is to leak their bad debts out over ten years, it is a fragile strategy and we have to hope that nothing upsets it. Finally, investors need to prepare themselves for low nominal returns in a world of low growth and low inflation.

Vaughn Henkel : Stanlib

There are 4 risks that we focus on at this time:

- The potential for a US recession. Our view is that it is unlikely within the next 12 months, but the potential impact on the markets for such a scenario is severe. This would impact the allocation to offshore asset classes. It is worth noting that our offshore cash position has steadily risen as the risk reward of offshore equities has declined (within the offshore allocation).
- The previous 6 years' strong returns post 2009, have resulted in an above-average valuation environment for offshore equity. We now expect a mid-single digit return in US dollars for the future; well below what we have experienced in the recent past.
- Finally the ZAR is a risk in two areas. Volatility of the currency impacts longer-term investment decisions. While the recent strength is welcome, long-term investment decisions typically are delayed and offshore investments remain strong for risk reasons. The second reason is that our equity market has become strongly offshore-focused (about 60% of earnings are from outside of SA) and the resulting strength is typically not good for our equity market.

Peter Brooke : Old Mutual Macro Solutions

- China hard landing: Excessive Chinese credit growth linked to mis-investment creates the potential for a credit crisis which will drag the world into recession.
- Fed policy error: The world economy cannot cope with a much stronger US dollar sucking liquidity out of emerging markets. The Fed cannot hike too sharply.
- SA politics: A downgrade is largely priced in, but multiple downgrades are not. Political resolve to back the NDP and deliver on structural reforms to improve our growth rate is crucial.

Is there an asset class that you won't invest in right now, and why?

Chris : We manage Investec Asset Management's balanced and equity strategies. Private Equity and direct property have natural liquidity limitations, which preclude us from investing, given that most clients require the flexibility of having their money back in 30 days.

Vaughn : While we cannot exclude asset classes entirely for risk reasons, we believe that the SA equity market is overvalued and the combination of weak economics, currency volatility, high valuation metrics and a very uncertain earnings environment make for severe headwinds.

Peter : Global bonds offer rewardless risk – as such they are unsuitable for long-term investing.

What is your position on gold (as an asset class) and on South African gold shares?

Chris : We are positive on gold, given that real interest rates globally are likely to stay very low and there are considerable uncertainties currently. The company management of South African gold companies is far more realistic than they used to be and are already running the companies on a tight budget.

Vaughn : In our view gold is a safe haven asset. To the extent that the global economic system is experiencing growth challenges that have resulted in very unorthodox monetary policy, we can see some value in gold ETFs as an insurance policy. However South African gold shares fail to deliver a good investment on a longer term view; due to the well-known issues about capex requirements, labour risk and regulatory challenges in both mining rights and the environment.

Peter : We see gold as a separate asset class within our allocation process and currently prefer gold shares to the physical metal. This is due to their improved free cash generation.

If Regulation 28 did not restrict your offshore exposure to 25% (for Balanced Funds), what percentage of assets would you hold offshore? Why?

Chris : We would hold in the region of 35% offshore, as we consider this to be an appropriate mix in terms of risk and reward.

Vaughn : According to research we have undertaken, over the long term, an offshore weighting of between 30-70% is appropriate depending on the economic cycle (more in stagflation and less in a South African growth phase). Clearly a portion of this is explained by the ZAR, which is structurally a weak currency. While we do not advocate for 70%, we believe the current 25% weight is too low and would welcome more discussion on this limit.

Peter : Our objective on our balanced funds is to deliver a real return of 4% to 5% and our modelling suggests global exposure of 35% is appropriate. However, we also look through our funds in an integrated manner, with very material dual-listed exposure actually increasing foreign exposure to more than 50% on a look-through basis. Finally, we will consider the outlook for the real value of the rand and potentially adjust for that. At the moment we think the rand is already very weak and there is a risk of rand strength suggesting wholesale shifting of investments overseas is too late.

What is your cash weighting?

Chris : This varies as we see opportunity. In recent months the percentage of local cash in the portfolio has increased, which is in accordance with our conservative portfolio positioning in current market conditions.

Vaughn : It is 35%, split between local and offshore cash.

Peter : The cash weighting in our balanced fund is over 20%. This is high by historical standards and reflects the higher returns offered on cash and lower expected returns from other assets. However, this is a temporary phenomenon and over time that cash will be invested as opportunities become available to ensure we deliver decent real returns.

If you could buy one stock for the next 50 years, what would it be?

Chris : Very few companies have a 50-year life span, but in terms of a good long-term outlook, we believe Tencent has a good long-term future.

Vaughn : In our view, a single stock would incorporate too much risk for a 50-year time horizon. Technology, management and business risk would not allow for such a long time period without monitoring it regularly. The SA equity market is the second best market over the past 100 years, however the prospective environment argues against taking such a risk again for such a long period. No asset class can be purchased and then forgotten for such a long period, and this is why we favour a balanced fund which allows for all asset classes and active management.

Peter: I would buy an ETF (exchange traded fund) on the MSCI All Country World Index. The pace of change and disruption is too great to tie yourself to a company that could be making the modern day equivalent of buggy whips.

If a 40-year old client gave you R10 million and asked you to invest it for future prosperity, how would you invest it?

Chris : I would find a well-resourced investment house with a good pedigree and a respected long-term track record and invest in their balanced fund. In a likely low return world, investors should consider letting the professionals decide on the appropriate asset allocation, with tactical asset allocation and good stock selection adding to market returns at the margin. This is not the time to be brave and swing for the fences.

Vaughn : We would follow our current positioning of 35% cash, 11% Bonds and 54% equities (primarily offshore equities and Rand hedge equities). Clearly this is a balanced fund and these weightings would change as the market presents us with a better opportunity to enter the riskier assets. Our more defensive view is clearly reflected in this allocation for now.

Peter : Firstly, I would choose a fund with high exposure to growth assets as that will deliver over the long-run. Secondly, I would use a multi-asset class fund as that allows flexibility over asset classes and value-add from active asset allocation. Thirdly, I would chose a worldwide fund as that gives more freedom in investing all over the world but still focuses on delivering for a South African client. Finally, I would chose

the Old Mutual Maximum Return FoF as that is where my money is invested and I believe in being "as invested as you are".

What are the three most important questions to ask the CEO of a listed company?

Chris Freund : Investec

1. How does the CEO plan to grow the profits of the company?
2. What are the major risks associated with doing business and how have they attempted to control or mitigate these?
3. The greatest single challenge for humanity today is sustainable development. This means the simultaneous achievement of economic growth, social inclusion and environmental sustainability. Is the company doing enough in this regard?

Vaughn Henkel : Stanlib

1. What are the management priorities? This will give insight into the strategy, the risks and the opportunities. It will also show if management are good stewards of shareholder capital.
 2. How long has the board been in place? This shows board independence, since the oversight mechanism of the board will limit the executive management from undertaking an investment that may put the company at risk.
 3. What does the balance sheet show? Companies face headwinds due to cashflow issues and every company will need to weather the occasional storm. This was very prevalent in the resources sector these past 12 months as balance sheets came under pressure in the commodity downturn. Fundamentally companies cannot have both business and financial risk at the same time.
- Although we were asked for three questions, we would also add that we would consider what industry a company is in. This is the most important criteria and is obviously not a question for the CEO. This is because a great industry is very forgiving of poor management but not vice versa.

Peter Brooke: Old Mutual Macro Solutions

1. What is your company's key strategic advantage?
2. Which financial metrics do you use to manage your company?
3. Please describe your capital allocation priorities and how you decided them?

What do you believe is a reasonable rate of return ex dividends in the current environment?

Chris : The days of 5% or more real returns are coming to an end. As an industry, we would do well to deliver returns 2% to 3% ahead of inflation in SA In the next few years. This will improve in time as conditions change, but given the current starting point, expectations should be subdued.

Vaughn : We believe mid- single digit returns is a reasonable rate of return for now. This does not compensate investors for equity risk.

Peter : Excluding dividends is a mistake as they will be one of the biggest drivers of real returns, especially internationally. We think SA equities will give a lower real return than they have historically - in the region of 5% real per annum. Unfortunately savers will have to get used to a lower return world, which means single digit returns from diversified portfolios.

Where do you see the markets going in the next six months?

Chris : As the first few months of this year have shown us, it is almost impossible to predict market movements in the very short-term six-month period.

Vaughn : Over the short term of 6 months, forecasting market return will have limited success, but seasonality studies show that the period of May to November tends to be a weak return period in history.

Peter : I can't answer that as it is a random walk over such a short period. We allocate our clients savings on a longer-term view using a five year real return framework. Currently, we are underweight our long-term allocation to South African equity, which shows we are more cautious on future risk adjusted returns. This is a function of higher valuations and a very tough environment for profit growth.