FUNDAMENTALS

THE NEWS MAGAZINE OF OLD MUTUAL INVESTMENT GROUP

JANUARY 2017

WHAT YOU'LL **FIND INSIDE**

TOP TRENDS IMPACTING OUR MARKET

HYWEL **GEORGE**

LONG-AWAITED GLOBAL RECOVERY TO GAIN TRACTION IN 2017

RIAN **LE ROUX**

MARKET REMAINS UNCONVINCED AS SA SIDESTEPS A DOWNGRADE

WIKUS **FURSTENBERG**

AT 50 YEARS, OLD MUTUAL FUND HAS DEVELOPED AN EYE FOR THE UNLIKELY

STEPHEN **CRANSTON**

FPI Financial Planning Institute of Southern Africa THE PROFESSIONAL STANDARD

0.5 CPD POINTS FPI members can claim 0.5 CPD points for this edition

OLD**MUTUAL** INVESTMENT GROUP

INSIDE THIS **ISSUE**

FOR MORE **INFORMATION**

JANINA **SLAWSKI**
Director of Marketing and Distribution
Tel: +27 11 217 1873
Email: jslawski@oldmutualinvest.com

WYNAND **GOUWS**
Head: Marketing
Tel: +27 21 509 5601
Email: wgouws@oldmutualinvest.com

TOP 5 **TRENDS IMPACTING OUR MARKET**

HYWEL **GEORGE** | DIRECTOR OF INVESTMENTS

ABOUT
THE AUTHOR

Hywel is responsible for the delivery of performance across Old Mutual Investment Group's listed asset management business. He is key in providing thought leadership to the business as well as nurturing and developing new investment products.

Stormy political developments, extreme volatility and fragile growth characterised 2016, both locally and on the global stage. Our fund managers, however, made investment decisions that focused on the long term and they were rewarded for holding the course.

Looking to 2017, here are some of the major trends I believe will be affecting our markets in the year ahead.

1. GLOBAL RISE OF POPULISM PRESSURES GOVERNMENTS

WHY?

With Brexit, the election of Donald Trump as US president-elect and growing support for ultra-conservative right-wing parties in Europe, developed country governments are coming under increasing pressure to deliver on the demands of – and, in the case of the US, promises to – their electorates.

After years of mediocre growth in the wake of the 2008 financial crisis, the gap between rich and poor has grown and voters have become increasingly disenchanted with the establishment, seeing politicians and the elite as often the primary beneficiaries of an economic system that appears to favour the wealthy.

The path of the US will be defined by Trump's transition from being a seemingly chaotic campaigner to having to govern effectively, while delivering on the many ambitious promises he made during the elections.

The UK's economic trajectory will hinge on the time it is likely to take to complete Brexit and the conditions associated with its withdrawal from the European Union. In Europe, the political ramifications of the constitutional referendum in Italy and elections in France in May will reveal how deep and wide support has become for populism.

HOW TO RESPOND

With global politics taking centre stage, it will be necessary to have a much deeper understanding of political developments – in order to discern between policies that are actually likely to be implemented and those that will become little more than political rhetoric. Of particular concern for SA are policies that impact trade and those that lead to increased volatility in the rand.

2. TRUMPFLATION BOOSTS GROWTH

WHY?

With Trump as president-elect of the US, we can expect more fiscal stimulus, higher inflation and, ultimately, higher bond yields. This policy stance is likely to be transposed onto other Western economies as politicians realise that if they impose more fiscal austerity, they could well lose office.

After eight years of quantitative easing (QE), more fiscal spending is exactly what Western economies need, along with a little more inflation. What are also needed are higher rates (for healthy banks and a better functioning savings and lending system).

HOW TO RESPOND

The shifting policy environment means we can expect more turbulence, a stronger US dollar (so global emerging markets are likely to come under pressure for a while), much higher bond yields and a speedier upward climb in interest rates instituted by the US Federal Reserve. In time, this pro-growth agenda should also translate into higher equity markets.

3. SOUTH AFRICA SURPRISES ON THE UPSIDE

WHY?

In SA, 2016 was characterised by anaemic growth, concerning political developments and the threat of sovereign rating downgrades. 2017, however, could be better than anticipated for the economy as many of the shocks experienced over the past few years have waned (electricity load shedding, commodity price collapse, rand slump and drought).

Positive developments could include the rand moving sideways or even firming, interest rates declining earlier than expected, the labour environment stabilising, business and consumer confidence improving, a reversal in food price inflation and commodity prices continuing to improve. Against this backdrop, economic momentum would build up and an upside surprise to growth may well be achieved.

HOW TO RESPOND

SA bonds stand to benefit from an upside surprise, given the higher yields they offer, making them attractive to foreign investors in a world where interest rates and prospective investment returns remain relatively low. The SA equity market would also perform well.

4. INVESTORS REACH FOR A BLEND OF ACTIVE AND PASSIVE INVESTMENTS

WHY?

Investors are now appreciating the numerous benefits of a blended strategy of both active and index investing, which include:

- Lower costs: Balanced index funds have lower costs than their active counterparts. This means a blended strategy would decrease overall cost, putting more of the return in the investor's pocket.
- Diversification: Holding a balanced index fund in a blended portfolio reduces the risk associated with holding just a single active balanced fund.
- Consistency and peace of mind: An active manager has discretion to change their asset allocation – which can result in outperformance but, equally, in underperformance. A balanced index fund, however, broadly maintains its asset allocation. And each asset class performs in line with the index representing that asset class due to the nature of this investment strategy. This ensures the investor consistently gets what they paid for, which translates into increased peace of mind.

HOW TO RESPOND:

Find an investment solution that blends active and passive funds to ensure you achieve optimum risk-adjusted returns and lower your costs. Indexation frees up both your fee and risk budget, which can then be allocated to higher-conviction active managers, giving investors the best of both worlds.

5. BUSINESS ACTIVELY ENGAGES WITH GOVERNMENT IN SA

WHY?

As the extent of corruption in many SA institutions is revealed, the partnership between business and right-minded government leaders will become more important. What began with a handful of senior business leaders meeting with Government in the wake of Nenegate and managing to negotiate the appointment of respected Finance Minister Pravin Gordhan, has evolved into the Save South Africa campaign – a movement that is supported by a wide group of concerned stakeholders, including business, clerics, trade unions, community groupings, former government ministers and several high profile ANC members. It is this partnership that helped prevent the second attempt to charge Gordhan with fraud and enabled the release of Thuli Madonsela's State Capture Report.

HOW TO RESPOND

Understand that domestic political risk is likely to remain elevated and that financial markets will be volatile, given the extent of foreign investment in our stock and bond markets. However, business's response underscores the importance they accord governance within SA and explains the resilience of the companies constituting our equity market. The united efforts to rid South Africa of its corruption should boost investor sentiment.

LONG-AWAITED GLOBAL RECOVERY TO **GAIN TRACTION IN 2017**

RIAN **LE ROUX** | OLD MUTUAL INVESTMENT GROUP'S CHIEF ECONOMIST

ABOUT **THE AUTHOR**

Rian is the head of the Economic Research Unit responsible for providing insight and forecasts of how macroeconomic developments may impact financial markets. This research informs the boutiques' top-down views.

The rally in the US equity market that started shortly after the US presidential election continued into the opening two weeks of December. By the middle of the month the S&P 500 Index had gained 9% from the four-month low reached early in November. The rally was essentially driven by a reassessment of the macroeconomic implications of a Trump presidency. This revised view concluded that serious global growth-damaging trade restrictions were unlikely to materialise and that decent fiscal stimulus would lend solid support to the economy without forcing the US Federal Reserve (Fed) to tighten policy much more than was expected before the election, if at all.

UNCERTAINTY CLOUDS US RATES OUTLOOK

Despite this revised view, at the conclusion of its meeting on 14 December, the US Fed cast considerable uncertainty over the outlook for monetary policy over the next year or two as their statement and press comments were considerably more hawkish than was expected. Over and above the widely expected 25 basis point hike in the federal funds rate, the individual Fed members' median forecast path for the federal funds rate changed from predicting two hikes of 25 basis points each in 2017, to three hikes. A further three hikes are currently foreseen in both 2018 and 2019. Over and above this, the Fed indicated that it did not take into account any changes to fiscal policy, as the outlook was still too uncertain. This implied that should fiscal policy indeed be eased notably, they might become even more hawkish in 2017.

However, there were additional reasons for markets to become more concerned over the outlook for US interest rates in 2017. Importantly, the economy grew at an upwardly revised, solid 3.5% annualised pace in the third quarter of 2016 and incoming data point to another solid expansion of about 2.5% in the fourth quarter. In addition, inflation has been drifting higher in recent months and wage settlements have also been rising as the labour market remains very tight.

RISING US YIELDS SIGNAL RECOVERY

As greater uncertainty set in over the outlook for US interest rates, the US equity market took a breather towards month-end and closed little changed from the all-time peak reached at mid-month. Nevertheless, we continue to hold the view that the normalisation of US bond yields and short-term interest rates are actually positive signals for financial markets, as they indicate that the long-awaited improvement in underlying economic conditions is finally materialising. The 10-year Treasury yield ended the year at 2.55%, the highest level since September 2014 and sharply up from the multi-decade low of 1.4% recorded early in July 2016. (Bond prices generally fall when interest rates rise and bond yields move inversely to bond prices.)

Elsewhere around the world incoming data has also been better recently – pointing to a more synchronised global recovery, even if it is still relatively moderate.

For some time now, we have been cautiously optimistic that global growth would improve moderately in 2017 as monetary policy stimulus continues to gain more traction. Not only is this starting to unfold, but the prospect of more expansionary fiscal policy in the US, and possibly elsewhere too, adds to our optimism over the outlook for the world in 2017. We also do not think that an aggressive counter monetary policy reaction will bring a premature end to the long-awaited, and much-needed, global economic improvement.

KEY TAKEOUTS:

- TRUMP'S TRADE RESTRICTIONS UNLIKELY TO MATERIALISE
- US FED ADDS ANOTHER RATE HIKE TO ITS 2017 FORECAST
- BONDS AND SHORT RATES SIGNAL A RECOVERY

GIVEN THE RIGHT NURTURING, **A LOCAL RECOVERY IS POSSIBLE**

RIAN **LE ROUX** | OLD MUTUAL INVESTMENT GROUP'S CHIEF ECONOMIST

Following the welcomed news early in December that all three major credit rating agencies left South Africa's sovereign rating unchanged at investment grade, the rest of the month was relatively uneventful. As a result, the rand traded in a narrow band and ended the year at around R13.70 to the US dollar, which still represented a sharp firming from the almost R17/US$ reached in mid-January 2016 in the aftermath of the President removing the then Finance Minister Nene.

2016 DISAPPOINTS

In contrast to the stronger rand, looking back at the economy in 2016 clearly reveals a year of considerable disappointment. At the beginning of the year consensus growth forecasts called for a 1.5% expansion in 2016, slightly better than the 1.3% recorded in 2015. However, as the year progressed, deeply depressed business confidence, increased financial pressure on households, a still weak export performance and a severe drought undermined the growth momentum of the economy. It now seems that growth will only be about 0.5% in 2016 – a considerably worse outcome than was expected at the beginning of the year.

Inflation also remained sticky, with the latest reading of 6.4% for November still above the top end of the 3% - 6% inflation target range. The sustained elevated inflation numbers left the South African Reserve Bank with no choice but to maintain interest rates at relatively high levels in the face of the slowing economy. In addition, the Finance Minister warned in his October medium-term budget review that fiscal policy will have to be tightened notably in the February 2017 Budget in order to ensure that fiscal consolidation (i.e. the narrowing of the annual budget deficit and stabilisation of overall government debt) is to be achieved over the next few years – a key requirement for maintaining our investment grade rating.

2017 HERALDS OPTIMISM

Looking forward to 2017, and despite the overall relatively poor performance of the economy in 2016, we repeat our caution of last month to guard against overpessimism about the outlook for the economy. While considerable risks still cloud the outlook — including the possible impact of further interest rate increases in the US, local political uncertainties and risks, and the still deeply depressed consumer and business confidence — it is important to remember that a number of shocks that hit the economy over the past few years are now fading or have disappeared altogether. Some of these include electricity load shedding, the commodity price collapse, the rand slump and consequent inflation and interest rate increases, a debilitating drought and consequent surging food prices, and an abrupt end to the consumer credit boom. Most of these adverse forces are now fading and so are becoming less of a drag on the economy.

It is even possible that some of these headwinds may turn into tailwinds in 2017, especially lower inflation and interest rates,

KEY TAKEOUTS:

- 2016: A YEAR OF CONSIDERABLE DISAPPOINTMENTS
- 2017: AVOID OVERPESSIMISM ABOUT THE ECONOMY
- SA ECONOMIC SHOCKS OF OLD ARE FADING

better conditions in mining and agriculture and keener foreign demand for SA's exports. Should these cyclical improvements be backed up by a less traumatic political environment and possibly even some growth-enhancing economic reforms, the deeply depressed consumer and business confidence may lift notably and thereby support a long-awaited recovery in economic growth.

The bottom line is that, despite the ongoing weakness in the economy and numerous risks in the outlook, there are some rays of sunshine finally starting to appear. With some fortune and a lot of nurturing, these rays could lead to spring for the economy – an outcome most currently find very difficult to envisage.

SECTOR OVERVIEW **AND OUTLOOK**

BRIAN **PYLE |**
OLD MUTUAL EQUITIES

INDUSTRIALS

COMPANY-SPECIFIC FACTORS DRIVE RETURNS

Globally, economic activity was buoyant in the US, while China continued to pick up. The outcome of the US election has added further uncertainty in the markets. Resources companies continued to bounce off their lows and stock markets in emerging markets improved. In South Africa, various economic and political events, dominated by the uncertainty around the potential sovereign downgrade, led to further volatility in the markets. The FTSE/JSE All Share Index (ALSI) returned -2.1% during the fourth quarter ending December 2016, with industrials returning -5.4%, while the rand strengthened against the US dollar by 0.55%. Despite the volatility in the market, there were still some opportunities to make money during the quarter.

Allied Electronics Corporation Limited (Altron), Barloworld and Net 1 UEPS Technologies returned 42%, 42% and 37%, respectively. There is no discernible "theme" from shares delivering strong returns as each company in that list has various company-specific issues that drove the share price move. For instance, Altron shares rallied on the back of news that the company was selling certain immovable property. Barloworld performed well after they released their results and sounded more upbeat about this being the bottom of the mining cycle. Net1 announced a deal to acquire a strategic stake in Blue Label Telecoms, which was well received by the market.

Poor returns were seen from Mediclinic (-22%), Cashbuild (-18%) and Trencor (-15%). Consistent with the shares that showed strong performance in the quarter, there is no discernible theme from the shares that delivered poor performance. Mediclinic's recent trading update surprised on the downside and highlighted that there is regulation overhang on the Middle East (UAE) and European (Switzerland) divisions.

The trailing price-earnings ratio of the Industrial Index continues to trade at a high level of greater than 20 times and well above the 10-year average. This does include highly rated Naspers, which has a large weighting in the Index. Against a backdrop of "high" valuation levels, fragile local fundamentals and a volatile stock market and rand, we continue to favour high quality companies that are defensive, with at least some offshore currency exposure.

Looking into 2017, global growth remains fragile and monetary policy should remain accommodative as long as inflation is contained. Locally, inflation has peaked and should start coming down; and there should be no more interest rate hikes. As a result, growth should be marginally better in 2017, further supported by a relief from the recent drought.

EVAN **ROBINS |**
MACROSOLUTIONS

LISTED PROPERTY

MERGERS, TAKEOVERS AND NEW LISTINGS

The SA Listed Property (SAPY) Index delivered a total return of 1.3% in the final quarter of 2016. Over this period, property outperformed the FTSE/JSE All Share Index (-2.1%) and the JSE All Bond Index (+0.4%), but was outperformed by general retailers (+2.1%). The property sector's yield became dearer compared to bonds.

For 2016, listed property's total return was 10.2%, while the All Share Index delivered 2.6% and the All Bond Index 15.5%.

The quarterly results remained robust despite the difficult operating environment. Few disappointed and no local REIT of size reported dividend growth of less than 6%. The period was busy with merger activity, with Redefine taking over Pivotal, Fortress taking over Lodestone and New Europe Property Investments (Nepi) and Rockcastle announcing a proposed merger swap ratio. The listed sector got further exposure to trophy assets like Sandton City with the listing of Liberty Two Degrees. Expansion into Eastern Europe continued, with Growthpoint, for instance, taking a significant stake of a listed Romanian fund.

The SAPY has a 7.1% forward dividend yield (excluding Attacq) compared to 8.9% on the 10-year bond.

Looking ahead, near-term distribution growth should exceed inflation. Vacancies may still increase in some sectors. A genuine recovery in conditions may take longer than many anticipate, with disappointing GDP growth; cost increases constraining net rental growth; and significant over-rentals on renewal in some pockets (our key concern, especially in offices also faced with significant potential new supply). Large malls remain robust, but oversupply in some nodes and tenant and medium-term consumer health are a concern. Bond yields are the key short-term driver of capital value volatility.

MARKET INDICES 1 JANUARY 2016 – 31 DECEMBER 2016

FTSE/JSE All Share Index (ALSI) 2.6% **|** FTSE/JSE Shareholder Weighted All Share Index (SWIX) 4.2% **|** FTSE/JSE Financial Index 5.5% **|**

NEELASH **HANSJEE |**
OLD MUTUAL EQUITIES

FINANCIALS

COST OF LIVING STILL HIGH, BUT OUTLOOK IMPROVING

The fourth quarter was characterised by a sigh of relief for the financial sector, both locally and globally. South Africa escaped with a one-notch downgrade to its local currency rating by rating agency S&P Global Ratings. The foreign currency rating, the key measure, remains unchanged. In the US, the election of Trump as president feeds through positively for financials sentiment – via rising US inflation and bond yields, which indicate that underlying economic conditions are finally starting to improve.

At home, we continue to be cognisant of political risks, while inflation is expected to slow and with it bring an end to further interest rate hikes.

The FTSE/JSE Financial Index returned 2.9% over the fourth quarter, an improvement on the third quarter. The Index has outperformed the FTSE/JSE Shareholder Weighted All Share Index (SWIX), which declined 3.2% over the same period.

Performance within the subsectors was divergent: the banks continued to regain lost ground to deliver a return of 11%, while non-life insurance rose 4.5% over the quarter. The life insurance subsector declined 2.2%, with real estate only marginally down.

Companies that performed well during the quarter were Transaction Capital, Barclays Africa and PSG. Detractors from performance were Reinet Investments and Old Mutual, both being impacted by the rand strength. Old Mutual was also being dogged by uncertainties around Brexit and their internal managed separation process.

Transaction Capital continued its positive run as the company puts its excess cash to use with acquisitions – the most significant one occurring in Australia. This will diversify its operations and earnings, while providing another long-term growth avenue for the group. With its rand-hedge qualities, Reinet's performance is impacted by the stronger rand through its investment in British American Tobacco and Pension Corp in the UK.

It is a tough operating environment for financial companies, characterised by soft SA gross domestic product (GDP) growth and risks of a higher bond yield. Consumer debt levels remain high, as interest rates have risen moderately to counter against the threat of higher inflation. The risk of a looming sovereign downgrade remains. Within this context, we prefer companies that have strong operating metrics and that are well capitalised.

IAN **WOODLEY |**
OLD MUTUAL EQUITIES

RESOURCES

PRECIOUS METALS SOFTEN, ALL ELSE SHINES

The Basic Materials Index came under pressure during the quarter, falling 1.2%. However, it remained a relative outperformer compared with the FTSE/JSE All Share Index's decline of 2.1%. Precious metals were the detractors, with the gold and platinum mining indices falling 35.5% and 33.1%, respectively. Sasol (in the chemicals sector) recovered during the quarter in response to a 15.8% rise in the oil price.

This quarter's commodity price movements were a tale of precious metals versus everything else. Precious metals fell in response to a strengthening US dollar, reflationary expectations of "Trumpnomics" and a more hawkish outlook from the US Federal Reserve. Brent crude rebounded strongly after OPEC announced an agreement to cut production for the first time in nearly a decade. Base metal prices firmed during the quarter, with the exception of nickel and lead. Copper was the standout, rising 13.9%. Bulk metals had a knock-out quarter, with iron ore and thermal coal up 40% and 23%, respectively. The recovery in industrial and bulk commodities that we observed in 2016 will only endure if the pace of global growth gains momentum.

The modus operandi of mining houses over the past few years was to drive unit costs lower with higher volumes. Having felt the pain induced by creating excess supply, management teams have adapted their strategies. Loss-making capacity is being cut and operations are being rightsized appropriately. The industry is poised to face the next mining up-cycle in leaner, more sustainable shape than it has been for most of this decade. The challenge for management teams will be to resist the temptation to invest indiscriminately when the good times roll in again.

Over the past 12 months, the fund has returned 53.0%. This compares with the Basic Materials Index's rise of 36.4%. In a peer group comparison, the fund is placed second out of the eight mining and resources funds.

MARKET INDICES 1 JANUARY 2016 – 31 DECEMBER 2016

FTSE/JSE All Share Industrial Index -6.3% **|** FTSE/JSE All Share Resources Index 34.3% **|** FTSE/JSE SA Listed Property Index (SAPY) 10.2%

MARKET UNCONVINCED AS **SA SIDESTEPS A DOWNGRADE**

WIKUS **FURSTENBERG |** PORTFOLIO MANAGER AT FUTUREGROWTH

ABOUT **THE AUTHOR**

Wikus manages a range of institutional and retail fixed income portfolios, which include income, core bond and flexible interest rate funds. He also heads up the Interest Rate team at Futuregrowth.

The fourth quarter of 2016 had its fair share of exciting and significant events. From a bond market perspective, the most significant development is arguably the sharp rise in US Treasury bond yields, which in turn exerted some upward pressure on many other bond markets, both developed and emerging. The bearish correction in global bond markets, specifically the US Treasury market, picked up pace following the surprise Trump victory. Bond bears focused on the president-elect's campaign promises of significant unfunded government spending, which, if it actually materialises, could boost final demand, inflation and, of course, state borrowing. These investor expectations, as well as strong economic data and the US Federal Reserve's well-telegraphed rate increase of 25 basis points (bps) at its last meeting of 2016, combined to trigger large-scale bond selling. As a result, the US 10-year Treasury yield spiked from 1.59% to end the quarter at 2.46%, leading to significant capital losses across the yield curve.

GLOBAL BOND ROUT SPILLS INTO SA

As could be expected, the global bond sell-off had a negative impact on the local bond market. During the fourth quarter, the yield of the benchmark R186 (maturity 2026) touched a weakest level of 9.16% in mid-November before closing the quarter 25bps lower at 8.91%. Over this same period, foreign investors reduced their RSA local currency debt holding by a sizeable R32 billion. Although still a mere drop in the ocean relative to the estimated total foreign holding just short of R0.6 trillion, it nonetheless contributed to significant market weakness as the secondary market experienced difficulty clearing the surplus stock. As a result, the JSE All Bond Index (ALBI) eked out a modest return of 0.35% for the quarter. It still managed a very respectable 15.5% total return for the calendar year, a far cry from the -3.9% ALBI return the previous year.

The combination of a more benign inflation outlook, low real yields and very wide inflation break-even levels contributed to a further rise in inflation-linked bond yields. The real yield offered by the benchmark R197 (maturity 2023) rose significantly – from 1.85% to a peak of 2.18% before closing the quarter slightly lower at 2.13%. With the whole real yield curve lifting to higher levels, the official inflation-linked bond index returned a disappointing -0.93% for the quarter. As a result, the total return for 2016 was dragged down to 6.1%. Cash rendered a return of 1.9% for the quarter and 7.4% for the calendar year.

PRESSURE MOUNTS FOR COMPREHENSIVE REFORMS

Regarding local data releases, the broader trends remain unchanged: very weak underlying economic activity, while the more recent deceleration in the rate of inflation had turned into a widely expected temporary acceleration. Some stabilisation in the external trade deficit is ongoing, although we still maintain that the somewhat smaller current account deficit remains too wide for comfort. This also partly explains the decision by the South African Reserve Bank (SARB) to maintain a neutral bias at the last few monetary policy committee meetings. Although, as per the October interim budget, the Minister of Finance failed to avoid marginal fiscal slippage relative to the fiscal targets set in February 2016, it should be seen against a very challenging external environment, particularly persistently low economic growth. Nonetheless, the risk of fiscal slippage remains a major concern, irrespective of the reasons.

DOWNGRADE STILL ON THE CARDS

Moody's rating agency made no changes to its South African sovereign ratings, remaining the most bullish of the three agencies. Fitch changed its previous "stable" outlook to "negative", implying a higher risk of a sub-investment sovereign rating. S&P Global Ratings, on the other hand, reduced the local currency rating by one notch, while retaining the overall "negative" outlook. With South Africa now on "negative watch"

KEY TAKEOUTS:

- BEARISH CORRECTION IN GLOBAL BOND MARKETS
- FOREIGNERS OFFLOAD LOCAL DEBT
- FISCAL SLIPPAGE REMAINS A CONCERN
- CREDIT HEDGES STILL PRICED FOR A DOWNGRADE

with all three major rating agencies, pressure to deliver on more comprehensive structural reforms instead of the recent piecemeal flurry of announcements remains. On a relative basis, the pricing in the credit default swap market (where investors can hedge themselves against the risk of default) suggests that the market is still priced for the country being downgraded to sub-investment grade. We remain in agreement with the market on the prospects of a future sovereign credit rating downgrade, based mostly on our inability to sufficiently address the structural impediments to growth.

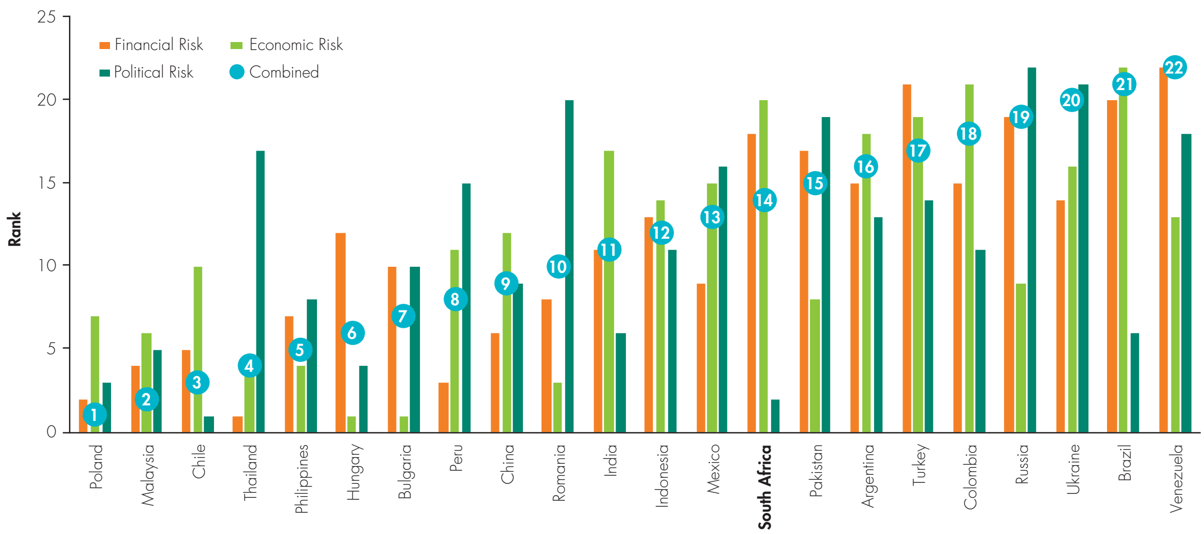
EASY MONEY POLICIES DISTORT PRICES

With the exception of the US, the global growth recovery remains fragile and patchy, which sets the scene for a modest future inflation profile as well as a continuation of monetary policy divergence. It also implies a steady and shallow tightening cycle for the few economies that are in a position to normalise monetary policy, especially the US. This should help cap global bond yields, especially following the past quarter's bearish correction. On the negative side, the continued uncertainty about the global, and particularly the Chinese, growth outlook remains a risk – especially for emerging market commodity producers with weak external positions in both absolute and relative terms, like South Africa. We also expect global risk appetite to remain volatile and do not regard market rallies boosted by expectations of more policy easing to be sustainable. If anything, we are starting to fear that the unintended consequences of unprecedented monetary policy measures among the major developed market central banks should not be ignored. Monetary policy has lost its effectiveness on final demand and has instead caused major asset price distortions, mainly across developed bond markets. This requires a change in the global policy mix. The impact of fiscal spending on final demand tends to be more effective, hence the eagerness by market participants to start pricing in the impact of the Trump campaign promises of significant unfunded fiscal spending.

Locally, we still expect a bout of upward pressure on inflation over the next month or two, but are more focused on the downward trend expected for the rest of 2017. While the SARB has now adopted a neutral bias, it is unlikely that they would consider interest rate cuts soon. The external trade imbalance is simply too big to allow for a lower real repo rate, while unpredictable currency swings continue to pose a risk to the more benign inflation outlook. Although the Minister of Finance is clearly determined to rectify the damage to fiscal policy credibility and, by implication, avoid a sovereign credit downgrade to non-investment grade status, the jury is still out on actual delivery of fiscal consolidation. Therefore, the risk

A RISKY INVESTMENT DESTINATION

At a broader level, South Africa ranks worse than average when compared with its emerging market peer group.



Sources: Bloomberg, Economic Intelligence Unit, Futuregrowth of a credit rating downgrade over the next 12 months still lingers. In the short term, local political uncertainty remains a nagging risk. This is particularly worrying considering how much risk has been priced out of the market over the past year, mostly the result of the global reach for yield, which has managed to whitewash the economic and policy sins of South Africa.

Considering the above, we will continue to approach the market with caution. The emphasis therefore remains on capital preservation. This is expressed by the large underweight modified duration and 12+ year nominal bond positions. We have reduced our inflation-linked bond holding in the past quarter in response to the more benign 12-month inflation outlook and have instead opted to create an overweight position in short- and medium-dated nominal bonds. The biggest risk to our cautious stance is sustained net foreign inflows into the local nominal bond market.

COURTESY OF BUSINESS DAY

AT 50 YEARS, OLD MUTUAL FUND HAS DEVELOPED **AN EYE FOR THE UNLIKELY**

STEPHEN CRANSTON, COLUMNIST AT BUSINESS DAY
(PUBLICATION DATE: 14 OCTOBER 2016)

AT THE HELM, THE INVESTMENT PROCESS HAS BEEN OVERHAULED BY CURRENT **PORTFOLIO MANAGER PETER LINLEY**.

- Peter Linley's general equity portfolio shuns obvious heavies for Naspers and Barclays Africa
- Old Mutual Equities concluded that Steinhoff was unfairly neglected and concluded that CEO Markus Jooste had the right vision

One of the best favours you can do for yourself is to set up a unit trust debit order as soon as you start working. With a 40-year plus horizon, it makes sense to invest in a simple equity fund and not worry about the other asset classes.

And it is best not to get preoccupied over whether your choice is the best performer in the sector: none has consistently outperformed. It is also critical not to switch in and out, even on days such as Tuesday, when prices were falling out of bed.

I chose to invest in the Old Mutual Investors' Fund, which had and has a solid reputation: I was lucky enough to find someone in the Old Mutual group who was prepared to waive the outrageous 3% commission agents and brokers received on each payment, although I couldn't get out of the nearly 3% initial charge from the management company. It is amazing what clients put up with in those days. Old Mutual Investors' Fund is now the oldest surviving unit trust in SA and the group celebrates its 50th birthday in October.

There were times in the 1980s and 1990s, when it seemed like a closet index fund, with few aggressive positions either radically above or below the index weighting of the share. It was considered a huge fund in those days, with R5bn under management. Multi-asset funds hadn't been thought about. The next largest fund, with about R3bn, was Syfrets Growth run by Tony Gibson and his colleagues, who in 1993, went to set up Coronation Fund Managers.

The investment process at the Investors' Fund has been overhauled by current portfolio manager Peter Linley, who will have run the fund for eight years in February 2017. Early 2009 was a great time to take over the fund. Linley came into the hot seat just six weeks before the trough of the market on March 9, and there has been a bull market for most of the time since.

Over five years, according to Profile Data, the fund is 14th out of 123 general equity funds with a 15.84% annual return. Funds such as Foord Equity, Investec Equity and Coronation Equity are all within a few basis points of this return, Allan Gray and Prudential are about one percentage point behind. Over time, there is often not a big difference in the returns from these flagship funds, so don't agonise about making the wrong choice if your fund lags in the short term.

For many years, Old Mutual had a unified, amorphous investment team. There was very limited personal accountability, and often the so-called portfolio manager was just the marketing face of the fund and did not pull the triggers. I can remember a very uncomfortable interview when it became obvious I knew more about the shares in the portfolio (which wasn't all that much) than the so-called fund manager. Old Mutual Asset Managers was highly centralised. A bell would ring before one of the endless committee meetings.

Now, it has been split into a number of focused teams. They are known, somewhat misleadingly, as boutiques, although other than Futuregrowth, they are wholly owned subsidiaries of Old Mutual SA. Linley's team, Old Mutual Equities, is small enough to be highly focused on a handful of funds. They don't worry much about what's taking place at the multi-asset-based MacroSolutions shop or the quantitative managers at Customised Solutions.

There are some talented analysts in the team. Brian Pyle, who runs the Old Mutual Industrial Fund, would be more than capable of running the Investors' Fund if Linley threw in the towel, and I would be quite happy if Tracy Brodziak, the head of research and veteran bank analyst, was drafted to do the job.

Other members of this eclectic group include Meryl Pick, a chemical engineer whose portfolio, improbably, includes gold shares and clothing retailers, as well as Ian Woodley, a mining engineer who is still remembered as the award-winning manager of the old Liberty (now Stanlib) Resources fund.

Linley calls the Investors' Fund valuation-based. It is certainly not a classic value fund in the mould of John Biccard's Investec Value. You can see that from the top holding in the fund, an exposure of more than 18% to Naspers. He says that even though the team is not obsessed with benchmarks, it has decided to hold at least a market weighting in the media giant, and possibly to go above it. He believes Naspers is undervalued, as once the holding in Tencent is stripped out, the rest — which includes some of the biggest online classified advertising businesses in emerging markets — trades at a discount to intrinsic value.

Linley is more choosy than you might expect with the rest of the fund. At one time, Investors' Fund would rarely leave out a blue chip of the JSE, but the fund now excludes heavy hitters such as FirstRand, Shoprite, Tiger Brands, MTN, Woolworths and Sappi. Linley says the investment process may look primarily at valuation, but it also looks at growth prospects and market sentiment. The team looks at the probability of a pay-back from investing in a share, looking at a base case as well as the bull and bear case.

A few years ago, the team discussed whether to back a rather unfashionable furniture manufacturer and retailer with a share price hovering around R22. It also meant making a call on the CEO, who was better known at the time for his antics on the racecourse than for his business acumen. But Old Mutual Equities concluded that Steinhoff was, in fact, unfairly neglected by the market and concluded that CEO Markus Jooste had the right vision for the business. The share is now at R76 and is the sixth-largest holding in the fund, between Old Mutual and Sasol.

Linley's largest holding after Naspers and British American Tobacco is, unlike most of the peer group, Barclays Africa. He says Barclays Africa was already trading at the team's base case level earlier in 2016, with all the possible bad news priced in. He was a keen buyer of the share during the May bookbuild. It is the only bank in the fund's top 10 holdings, which also includes Remgro, Netcare, MediClinic and Reinet. It does invest in smaller cap shares. Current picks include Peregrine, Italtile and Transaction Capital.

PASSIVE INVESTING IS AN **ACTIVE DECISION**

KINGSLEY **WILLIAMS |** CHIEF INVESTMENT OFFICER: INDEXATION

ABOUT **THE AUTHOR**

Kingsley is the Chief Investment Officer of the indexation capability within the Customised Solutions boutique. He is responsible for the indexation fund management process and for managing the Indexation Investment team.

Active investment strategies aim to outperform a particular benchmark through security or asset class selection and timing, while index investing (commonly referred to as "passive", although we much prefer the term "indexation") offers lower fees while generating consistent market returns. For clients, active investing and index investing are often presented as a case of either-or and not both. I believe that both have an important role to play.

THERE ARE INDEED NO "PASSIVE" INVESTMENTS

As Old Mutual Customised Solutions, which houses both consistently top-quartile performing actively managed funds and the largest index tracking investment capability in South Africa, we believe that there is no such thing as "passive" investing. From choosing what asset classes to invest in and in what proportion (i.e. your strategic asset allocation), to deciding what investment strategy to adopt within each asset class and the benchmark, and, finally, the choice of asset manager(s), are all active decisions.

WHAT'S HAPPENING GLOBALLY?

Globally, the asset management industry is still dominated by actively managed investment strategies, with close to 80% of assets under management. These strategies play a vital role in the price discovery process to ensure assets are valued correctly relative to their risk, and to ensure investors are compensated with appropriate returns on their capital. Currently, indexation only represents 11% of the market globally, but is expected to grow to over 20% by 2020[1] – representing trillions of dollars flowing out of active and into indexation and alternative investments (see Figure 1).

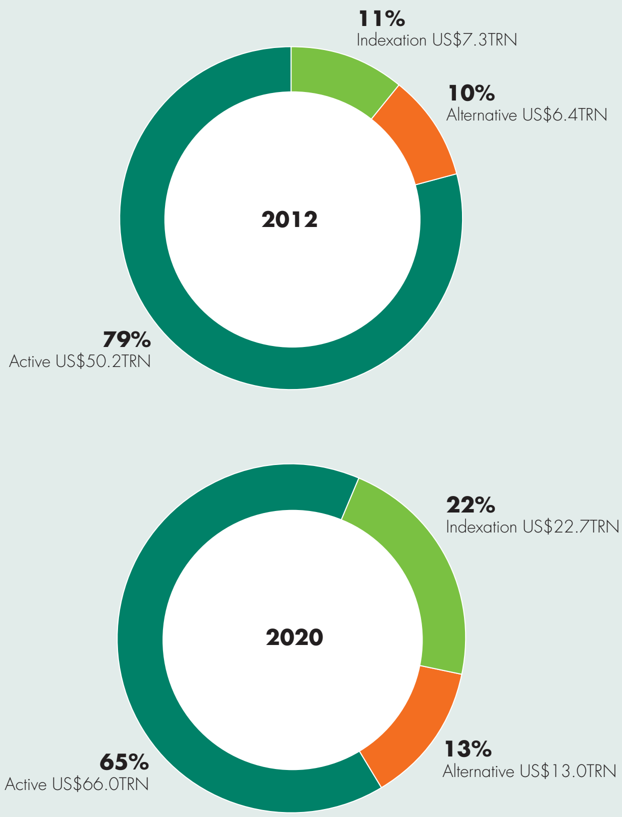
In line with this global trend, South African investors are recognising the value indexation can offer to their portfolios by lowering costs and reducing the risk of underperformance.

BEST OF BOTH

By using indexation to lower costs and provide more certainty relative to the chosen benchmark, investors free up both their fee and risk budgets, which can be allocated to higher-conviction active managers – the best of both worlds!

So why the hesitancy by some investors to use indexation? Well, for one, criticism has been levelled against free-float

FIGURE 1:
EXPECTED GROWTH OF INDEXATION GLOBALLY



[1]Sources: PwC - Asset Management 2020: A Brave New World, 2014 (PwC analysis, LCI, Lipper, Hedge Fund Research, Preqin, The City UK and Towers Watson)

KEY TAKEOUTS:

- MASSIVE SHIFT EXPECTED INTO INDEXATION
- PASSIVE FREES UP FEE AND RISK BUDGET FOR ACTIVE BLENDING
- BOTH ACTIVE AND INDEX SOLUTIONS HAVE A ROLE TO PLAY

market capitalisation weighted indices, either due to the large concentration of certain securities or, in the fixed income space, because the more indebted an issuer is, the larger the weight that issuer will have in the index. The reality is these indices merely identify the investable opportunity set available to all investors and measure the collective returns investors within that particular asset class have, on average, achieved. If a particular company or issuer has a large weight within a free-float market cap weighted index, it simply means investors collectively own that proportion of the company/issuer and have valued it as such. The companies/issuers wouldn't have these valuations or weights in an index without investors having allocated capital to them – the index is merely the messenger conveying, or the mirror reflecting, where the investment industry has, on aggregate, allocated capital.

Indexation has the added benefit of not being confined to tracking only free-float market capitalisation weighted indices. Alternatively weighted indices can also be tracked to address specific investment requirements. From capped market capitalisation weighted indices that address security concentration concerns, to indices constructed and weighted on metrics outside of market capitalisation (commonly referred to as "smart-beta"), we truly live in an age in which we are spoilt for choice!

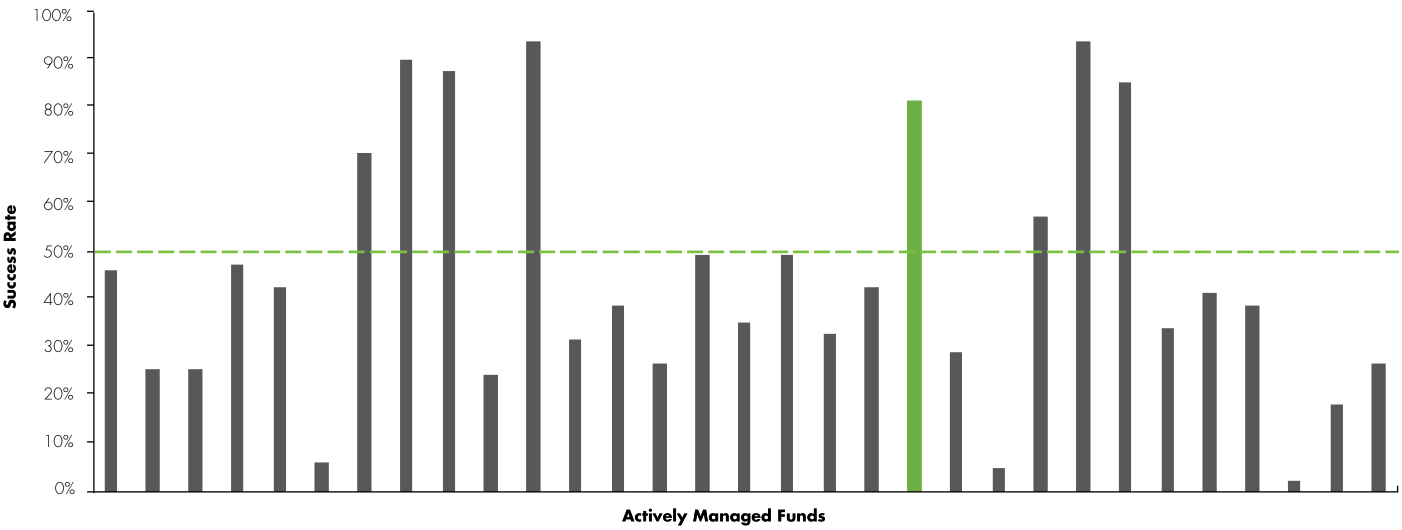
THE IMPACT ON ACTIVE MANAGERS

It is hardly surprising that the traditional active management industry is nervous about the growth in indexation, particularly when up to three-quarters of South African actively managed equity funds have underperformed the index over the last 6+ years, even before factoring in their fees[2] (see Figure 2). Faced with these odds, and coupled with the time-consuming, costly and highly uncertain exercise of trying to identify a manager most likely to outperform in the future, investors are recognising the value and peace of mind indexation has to offer through the certainty and cost effectiveness it provides. While it is true a market cap weighted indexation investment strategy is likely to guarantee a small degree of underperformance relative to the market index after fees, the order of magnitude should be in the region of the fees charged (assuming your index manager is doing their job properly), and will be insignificant relative to underperforming active strategies, even before their higher fees come into play.

RECOGNISING THE VALUE OF BETA

Over time, academics and investors have reached a better understanding of the composition of returns, and have refined what actually constitutes "alpha". We believe that "beta" is

FIGURE 2: SUCCESS RATE OF ACTIVELY MANAGED FUNDS AGAINST THE FTSE/JSE SHAREHOLDER WEIGHTED INDEX (SWIX)* (AS AT SEPTEMBER 2016)

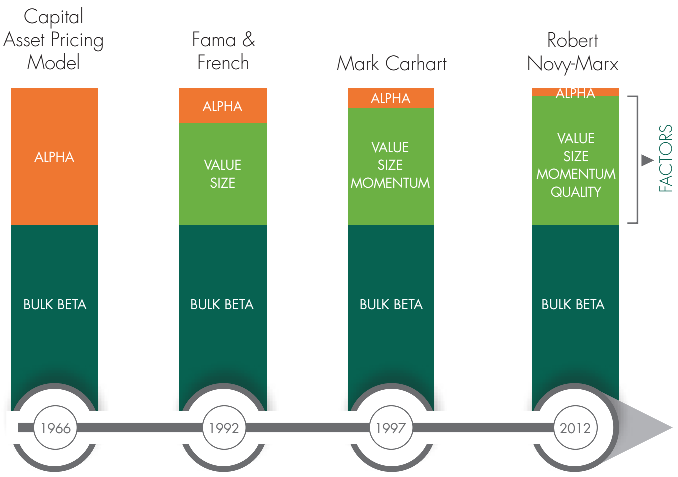


*Percentage of time at each monthly rolling three-year return that each actively managed fund was ahead of the SWIX.
Source: Alexander Forbes S.A. Equity Manager Watch™ Survey | Jan 2007 – Sep 2016 | All returns are gross of fees

[2]Source: Alexander Forbes S.A. Equity Manager Watch™ Survey | Jan 2007 – Sep 2016 | All returns are gross of fees.

the cornerstone of portfolio construction and that the pursuit of alpha should not compromise on returns from beta. As such, cost-effective, technology-dominated indexation solutions can add significant value to a fund's overall portfolio construction. Smart-beta indices aim to capture sources of returns previously perceived as alpha (as illustrated by the "factors" in Figure 3). We believe the introduction of these indices poses a threat to traditional active managers. As further investment strategies are offered via a more cost-effective index tracking investment process, these traditional sources of "alpha" could become more commoditised and thereby erode the fees active managers are able to charge. However, these factors, if packaged individually as funds, do result in more extreme performance (both positive and negative) relative to the market overall – depending on which factor is driving performance at a given point in time. For instance, the "value" factor is one of the most widely used by active managers, but it has resulted in underperformance since 2003, to which many an underperforming active manager can attest. Few investors are able to stomach the losses or underperformance concentrated exposure to any one factor is likely to produce while waiting for it to pay off. A diversified approach to managing exposure to these factors is therefore necessary. This requires an active investment process, whether implemented by the investor through varying the allocation to different smart-beta building blocks through time, or implemented by the asset manager.

FIGURE 3: THE REDEFINED SOURCES OF RETURNS



Sources: Eugene Fama and Kenneth French, The Cross Section of Expected Stock Returns, Journal of Finance, June 1992; Mark Carhart, On Persistence of Mutual Fund Performance, Journal of Finance, March 1997; Robert Novy-Marx, The Other Side of Value: The Gross Profitability Premium, Journal of Financial Economics, April 2013.

SOME WIDELY USED RISK FACTORS

MOMENTUM
Companies with share prices that have kept rising.

VALUE
Shares that are cheap relative to the company's longer-term value.

EARNINGS QUALITY
Profitable companies with stable earnings and low debt levels.

EARNINGS YIELD
Companies with higher-than-average dividend yields.

VOLATILITY SENSITIVITY
Shares delivering excess returns, but with lower volatility than the index.

Smart-beta has made the drivers of active managers' performance more transparent. Traditional active managers whose performance is effectively driven only by a consistent exposure to one factor, will be easily identified as not adding real value. True skill and consistency will become more apparent and will be rewarded.

ASSET ALLOCATION IS WHAT REALLY MATTERS

The active versus passive debate has received much attention and may give investors the impression that this is the most important of the decisions they need to make. The reality is that the strategic asset allocation decision is far more important in achieving your investment objectives.

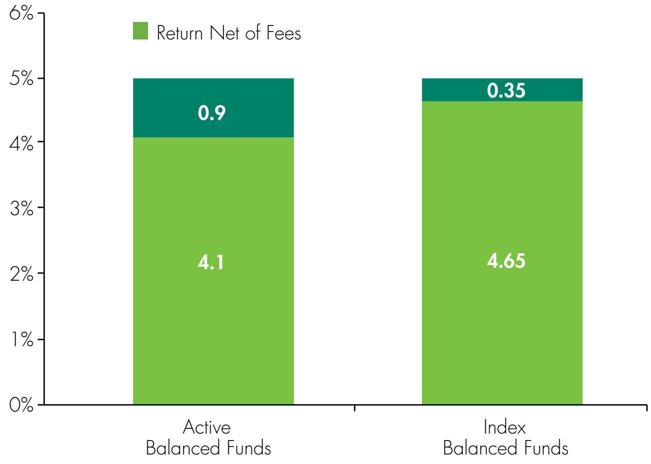
One important decision for an investor to make regarding asset allocation would be whether to try to add value through tactical asset allocation. Tactical asset allocation is the implementation of short- to medium-term tilts away from the long-term strategic asset allocation of a fund. Just because an indexation investing approach has been adopted within a multi-asset class fund, it needn't mean tactical asset allocation should be foregone. Many of our institutional clients adopt this "best-of-both" approach by getting certainty of performance within a particular asset class via an indexation investment strategy, while at the same time adding value through tactical asset allocation decisions within their multi-asset class fund.

Our index balanced funds do not use tactical asset allocation. The risk of incorrect tactical asset allocation calls is eliminated by maintaining the strategic asset allocations, which are driven by investors' risk and return requirements and investment horizon. This again frees up the risk and investment management fee budget to allow investors to allocate to their higher-conviction balanced fund managers, rather than blending with lower-conviction managers purely for diversification purposes.

By blending balanced funds together, investors move towards a market average asset allocation – one manager may be overweight to equities, while another may be underweight – leaving the investor near a strategic or an average asset allocation. Investors want this to mitigate the risk of one manager getting it wrong, but it can be achieved far more cost effectively by investing through an index balanced fund appropriate to an investor's risk tolerance and return objectives.

Incorporating a lower-cost index balanced fund into an investor's portfolio of active balanced funds will reduce the cost to the investor without detracting from returns. To put these savings in context, fees should be seen as a percentage of the returns above inflation (real returns), which is ultimately what investors are paying a balanced fund manager to deliver. To illustrate this (see Figure 4), a fee of 0.9% with a real return expectation of 5-6% translates into a cost to the investor of between 15-18% a year, while a fee of 0.35% with the same real return expectation would only cost the investor 6-7% a year. Index balanced funds are therefore a very cost-effective way to achieve diversification and predictability of performance, both at asset allocation level and within each asset class.

FIGURE 4: FEES AS A PERCENTAGE OF REAL RETURN EXPECTATIONS



Source: Old Mutual Customised Solutions

WHAT DOES THIS ALL MEAN FOR INVESTORS?

Indexation is a growing trend globally and is likely to continue as more investors come to terms with the role it can play, and the benefits it can offer, in achieving their investment goals. We do not believe it has to be indexation at the expense of active strategies, but see both indexation and actively managed investment strategies playing an important role in giving investors the choices to best achieve their investment objectives. Old Mutual Customised Solutions is perfectly positioned to provide a one-stop shop offering solutions across the full spectrum of investment offerings.

MARKET INDICATORS AS AT 31 DECEMBER 2016

	DY %	P/E Ratio	1 Month %*	12 Months %*
FTSE/JSE All Share Index	2.9	22.8	1.0	2.6
FTSE/JSE Resources Index	2.2	31.9	-3.6	34.2
FTSE/JSE Industrial Index	3.0	15.5	1.8	-6.6
FTSE/JSE Financial Index	4.6	14.5	3.5	5.4
FTSE/JSE SA Quoted Property Index	5.9	16.8	4.2	10.2
ALBI BEASSA Bond Index			1.6	15.5
STeFI Money Market Index			0.6	7.4
MSCI World Index (R)			-0.1	-4.6
MSCI World Index (US$)			2.4	8.2

*Total return index percentage change

Economic Indicators		Latest Data	Previous Year
Exchange Rates			
Rand/US$	December-16	13.7	15.5
Rand/UK Pound	December-16	16.7	22.6
Rand/Euro	December-16	14.4	16.8
Rand/Aus$	December-16	9.9	11.3
Commodity Prices			
Gold Price (US$)	December-16	1150.6	1060.8
Gold Price (R)	December-16	15863.3	16446.6
Oil Price (US$)	December-16	56.8	37.3
Interest Rates			
Prime Overdraft	December-16	10.5%	9.8%
3-Month NCD Rate	December-16	7.4%	6.8%
R186 Long-bond Yield	December-16	8.9%	9.8%
Inflation			
CPI (y-o-y)	November-16	6.6%	4.8%
Real Economy			
GDP Growth (y-o-y)	September-16	0.7%	1.1%
HCE Growth (y-o-y) (Household Consumption Expenditure)	September-16	1.1%	1.6%
GFCF Growth (y-o-y) (Gross Fixed Capital Formation)	September-16	-5.2%	3.4%
Manufacturing Production (y-o-y) (seasonally adjusted)	October-16	2.5%	4.6%
Balance of Payments			
Trade Balance (cumulative 12-month)	November-16	$0.1	-$4.8
Current Account (% of GDP)	September-16	-4.1%	-4.5%
Forex Reserves (incl. gold)	November-16	$46.7	$47.0

Sources: JSE, Iris, I-Net

OLDMUTUAL INVESTMENT GROUP

Old Mutual Investment Group (Pty) Limited. Physical address: Mutualpark, Jan Smuts Drive, Pinelands 7405. Telephone number: +27 21 509 5022