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Quarterly Commentary March 2015

Allan Gray/Orbis

Allan Gray/Orbis are going through a soft patch. Our long-time clients may have forgotten the excellent results that Allan Gray/Orbis delivered in 2012 and 2013, and that over a three year period their Rand returns in our largest offshore holdings have been excellent – probably the best in the country. The Allan Gray Global Fund of Funds, a balanced offshore strategy, is up 23% per annum compounded over a three year period. In the technological age we all live in however, three years is a long time. At a glance on my Samsung smart phone I can now tell you who gave the best returns yesterday, last week and last year.

The reason for the underperformance of Allan Gray is simple but very frustrating to say the least. They are foregoing the more expensive, momentum driven markets, in favour of the cheaper markets in the East, such as South Korea. Furthermore, their stock picks are also underperforming their respective markets, which is a temporary drag on their performance. Lastly, they have significant exposure to the Euro which has depreciated against the Rand over the past year. This raises the point that we generally all focus and judge our portfolios on the price of the USD, which has appreciated against the Rand, but our portfolios also have exposure to the Euro which has fared badly. We do however believe that the Euro should start recovering from these levels in the near future.

We cannot remember a time when it made good financial sense to panic, and to change from one manager with a fantastic record over the medium to long term, in favour of the best performing manager of the month or the year.

In 2012/13 Allan Gray attracted billions of Rands of new investments because they were the best performing house in South Africa. All of those investors who chased those returns with Allan Gray at that time, have ironically now gone through a period of underperformance. Many clients are questioning whether we should move away from Allan Gray and chase the best performing strategies.

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For both of our benefits, we are going to stay the course with Allan Gray. We have queried Allan Gray this week, and they have reminded us that their best performance almost always follows a period of underperformance. We have yet to find an Investment House, or an adviser for that matter, that is always right.

Coronation Portfolio Managers

Allan Gray have closed their overseas accounts for future business until further notice, due to offshore capacity constraints. We thus chose Coronation Portfolio Managers, on the Allan Gray platform, to accommodate further offshore investments.

We are mainly supporting **two offshore funds/strategies.** One is a conservative option - **the Coronation Global Capital Plus Feeder Fund** and the other an aggressive option - **the Coronation Global Emerging Markets Flexible Fund**.

Both have done well over the past 12 months, but only following the Global Emerging Market Fund rebounding 7% during the first week in April. If one can ignore the short term volatility, we believe the Coronation Global Emerging Markets Flexible Fund will outperform over the next 3-5 years. Its largest country holdings are Brazil, China and India.

Franklin Templeton Offshore

Russia, China and Japan were the best performing markets in USD this last quarter. We have significant exposure to China and Japan, whilst we have limited exposure to Russia. Our best performing Franklin Templeton Fund for the quarter was Japan, which was up USD 13.46%.

As I write, our China position in Franklin Templeton has broken out of a multi-year slumber, and it is doing reasonably well. The Chinese authorities opened the Hong Kong market up to mainland Chinese investors in November, with capacity limitations, and for the first time all the daily capacity available to mainland investors has been snapped up - Chinese shares listed in Hong Kong have since surged.

We are monitoring the valuations of the shares we hold very carefully - we feel this is the start of a multi-year bull market in China and Asia - and we are prepared to sit out any volatility with a 5 year outlook in mind. A warning though, we expect a bumpy ride!

Asia is also the best performing region globally since the beginning of the year through March, up USD 6.9%, and as mentioned it is no secret that we believe the markets in Asia, including China and Japan, will outperform the rest of the world over the next 5-10 years.

Our reasoning is not rocket science - Asian markets are far, far cheaper than the developed markets in the West. Most of the Asian countries also have stronger balance sheets, greater foreign currency reserves, better demographics and much less debt than their Western counterparts.

Furthermore, our Franklin Templeton portfolios are being assisted this month by a very weak jobs report emanating out of America on Good Friday. The American economy produced far less jobs in March than was expected, and the amount of jobs created in the months of January and February were also revised down – this is quite contrary to the supposed American recovery that most investors have hung their hats on.

We are hoping, but cannot guarantee that our Franklin Templeton USD portfolios have seen the worst and that they should, from here on in, produce very acceptable USD returns over the next couple of years - notwithstanding another global financial crisis.

Whilst we are relieved that our portfolios are recovering and doing well this year, we are still a very long way from where we would like to be.

This weak jobs report calls into question the timing of an American interest rate hike. This "imminent" interest rate hike, the one the market has been expecting for some time, is the reason why Emerging Markets, including the Asian Emerging Markets we favour, have been under so much pressure these past couple of years.

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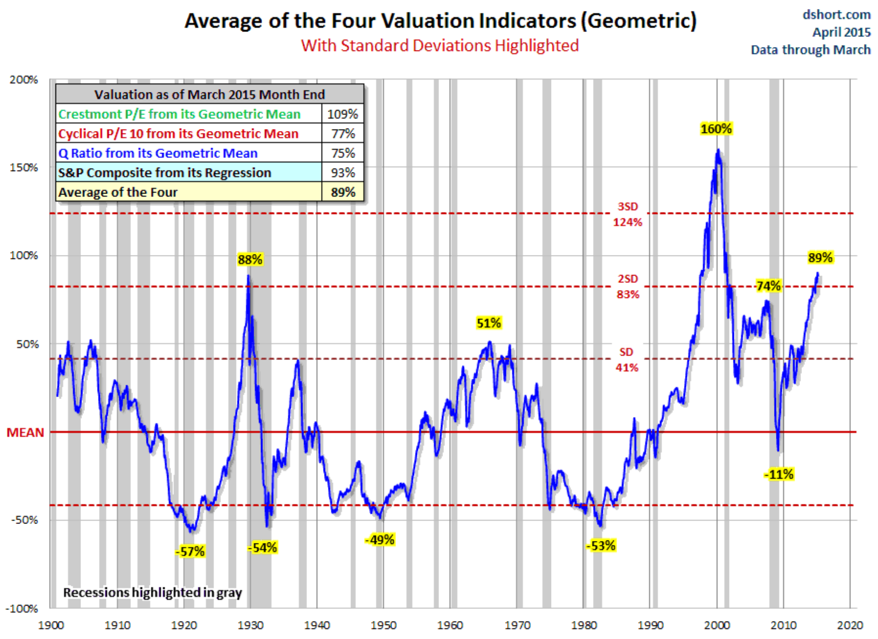
Personally, I think it is inconceivable that an economy the size of America cannot afford to raise interest rates by a mere 0.25% (one quarter of one percent), from a zero base, for the first time in 10 years without the markets reacting with shock and horror. These developed nations' finances are in such bad shape that they will probably never be able to justify normalizing their interest rates in our lifetimes (unless unpredictable market events force them to).

The European Central Bank also announced its Quantitative Easing programme this last quarter – this in an attempt to offset a deflationary environment in Europe. The Euro has recently sunk against almost all currencies including the South African Rand – the negative effect of this is evident in our local portfolios owing to the exposure Allan Gray/Orbis has to Europe. This follows the unprecedented money printing regime provided by the Federal Reserve in America over the last 5 years.

The results of these actions by Central Bankers in developed markets has created a very dangerous scenario in our opinion - their stock markets have soared in lieu of the liquidity provided by the bankers, yet this is not the result of improved economic fundamentals which would benefit all citizens.

At the risk of being repetitive, I alluded to the American stock market only being this overvalued on two other previous occasions in the last quarterly commentary. Below is the very latest chart clearly depicting our concerns for your benefit.



A well-known and reputable American analyst, Doug Short, used the average of four different valuation methods in the chart above in accurately determining that American shares have been this expensive on only two other occasions in the last century: The technology bubble of 2000, and the 1929 market mania which led to the Great Depression.

At some stage the latest surge in valuations depicted by the blue line on the right will have to come down; we have no idea when, or what the catalyst will be. We can only hope it is a gradual process, because if the move is violent, it will be very difficult to defend a share portfolio no matter where you are invested.

We are trying to be prudent with your money and benefit from a rising market, but also protect you in the case of a market crisis. At some stage in America the music stops - it always does - and it is our primary responsibility to ensure that your portfolio can at all times withstand a serious and unexpected market dislocation without permanent and lasting damage.

Nothing we have seen this last quarter leads us to believe that we should change from our present course. We are overweight the cheaper Emerging Markets in the East and have no exposure to expensive Western developed markets.

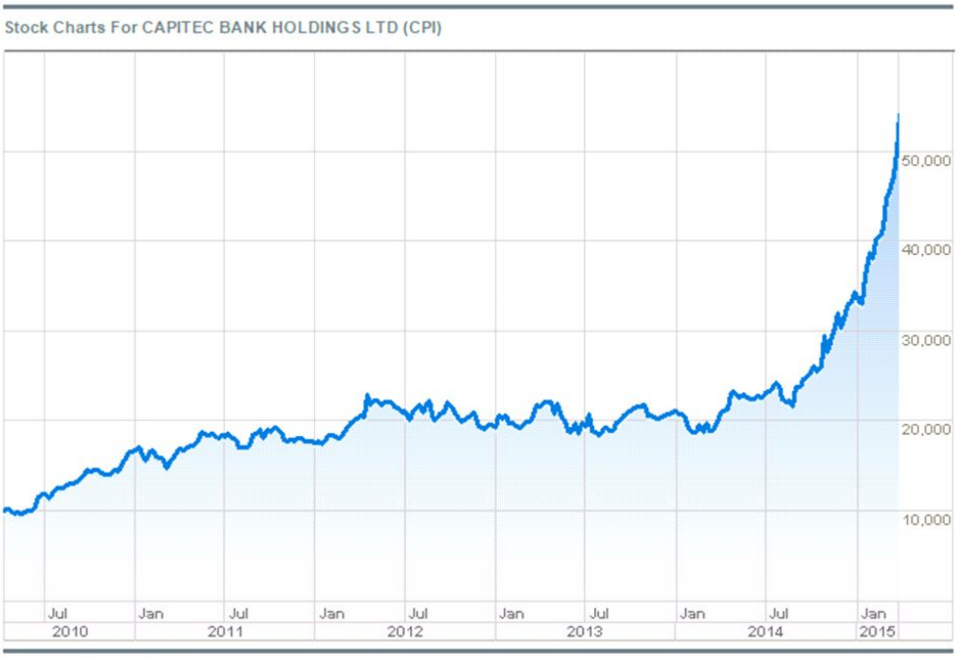
South Africa

Both Allan Gray and ourselves continue to be incredibly surprised at the performance of the South African market – but also alarmed. It trades at all-time highs and alongside America it competes as one of the most expensive markets in the world, against a backdrop of the numerous concerns plaguing South Africa at the moment.

Within our market there is a particular share that epitomises the irrational exuberance that we would normally equate with a lasting crest in a market following a long bull market. At the bottom of a bear market, pessimism reigns supreme, and thus there are very few buyers to be found – the complete opposite occurs in a sustained bull market where buyers and optimism abound.

That share, is CAPITEC BANK.

Below is a chart depicting the price action of this company over the past 5 years:



Source: Bloomberg

Last year African Bank collapsed, and every investor - even the moms' and pops' invested in Money Market funds – lost money.

Capitec, whose business model is very similar to African Bank, has since defied both logic and gravity, and has subsequently soared to new highs, as the above graph conveys. This is classic bull market behaviour where risk is completely ignored! Despite the fact that Capitec has better economies of scale than African Bank and a reported capital ratio of 39%, which is considered robust, their primary business is still lending money to low-income individuals at exorbitant interest rates - interest rates that neither you nor I would consider charging our domestic assistance!

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In our opinion, the individuals who take on this debt will never be able to repay Capitec Bank in full, simply because the interest rates are too onerous. Capitec's rates in the first year, including initiation fees and interest, are close to 50%. Who, at any stage in our lifetimes, could afford to service debt at those rates?

If you study the price of Capitec in the chart above, you will see it is benefiting from what we call the "Eiffel Tower Effect". A wide base forms over a period of time, and suddenly the share price of the company goes exponential, almost straight up, as more and more investors pile into the share for no reason other than it is going up.

There is a fundamental problem with a move of this nature in any share or index, and this we guarantee; when it eventually reverses course the price will not go sideways, but will go down in exactly the same fashion it went up - hence the term "Eiffel Tower".

Once again I have no idea what the catalyst for such a move would be, but this exuberance in the market currently warrants caution. Financial history is littered with investors all piling into a share or an asset class with disastrous results.

We thus continue to adopt a conservative approach with a strong offshore bias for our South African clients.

Should you have any queries, please do not hesitate to contact us.
We would like to thank each and every one of you for your continued support.

Kind Regards

Mike Carruthers

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