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Quarterly Commentary June 2015

Brief Overview

- Greece: Global markets are on a knife edge with Alexis Tsipras, the Greek Prime Minister, stunning the markets by walking away from negotiations and calling a referendum where Greece voted no to the EU rescue package. This comes after 5 months of fractious negotiations with the IMF and the Europeans, and now it's possible that Greece will leave the Euro, and furthermore the European Union.
- JSE: The Johannesburg Stock Exchange has posted a 0.27% return this past quarter.
- Rand: ZAR depreciated 0.48% against USD the past 3 months.
- Asia: Amidst extremely volatile markets, our house view remains that Japan, China and Asia present the best opportunities moving forward, but only if one is prepared to ignore short term volatility and look across the valley.
- Capitec Bank – a share we focused on in our last quarterly commentary – has lost close to 30% since its peak in April, and is ominously tracking the Eiffel Tower pattern we alluded to.

Despite difficult and volatile global markets overshadowed by the on-going Greek crisis, we still had a reasonable quarter for both our South African clients and offshore in our USD Franklin Templeton portfolios. The first week of July has seen the sell-off in global equities intensify however, Asia included, as the Greek crisis escalates.

Let us delve deeper into what the markets are currently telling us.

Greece

Greece has a population of 11 million and its output makes up a fraction of global GDP. Their total debt is approximately USD366 billion, or 180% of their GDP - i.e. their debt is approximately double the yearly output of the entire nation. This equates to $33 000 for every Greek man, woman and child, making Greece currently the second most indebted nation in the world.

Greek unemployment stands at 26%, unemployment amongst the youth is now in excess of 50% and they have lost 25% of their GDP since 2007. Greece is therefore in a very similar position as America was in the height of the Great Depression.

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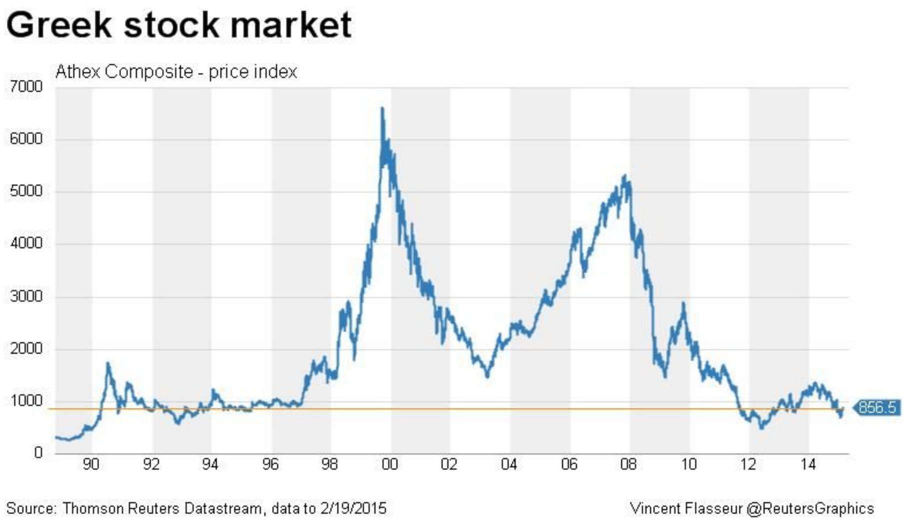
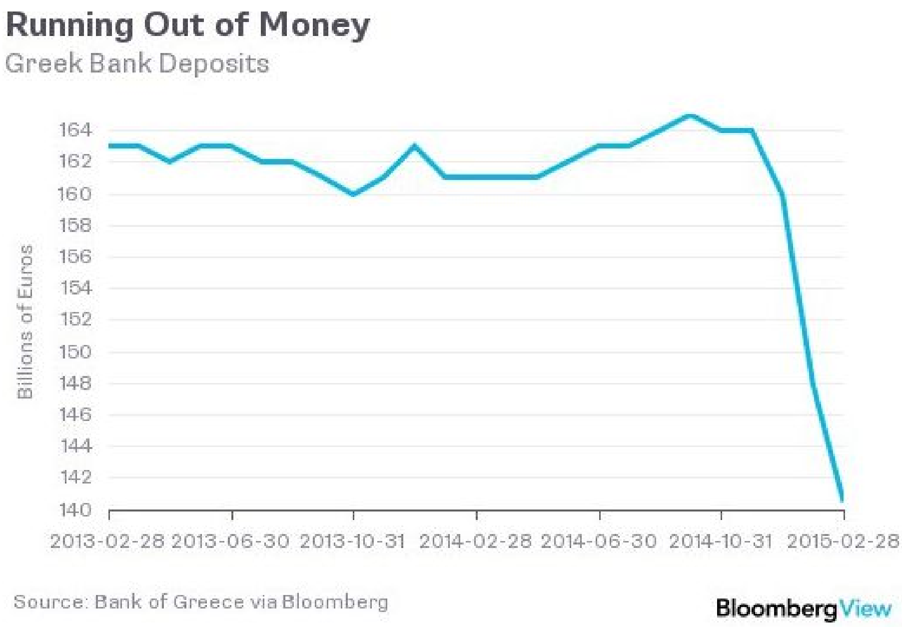
After 5 years of kicking the can down the road and 5 months since Alexis Tsipras was elected Prime Minister on an anti-austerity campaign, the Greek crisis is finally unravelling - Greece now being the first developed country in 71 years to default on their debt. This last fortnight saw Greek stock markets and Greek banks closed, as well as capital controls imposed on the Greek people in the form of a 60 Euro per day withdrawal limit on their deposits.

In light of the above, it is simply impossible for Greece to honour their debts. Below are the charts of the Greek stock market and Greek bank deposits. Both clearly illustrate the crisis Greece – and by extension Europe – is facing.





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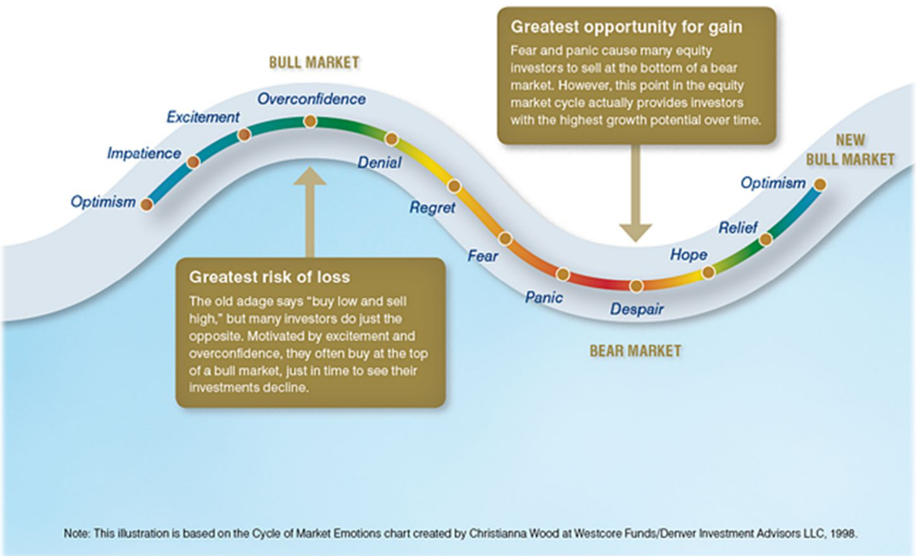
Needless to say, we are expecting an extremely volatile quarter. Whilst we do not have exposure to Europe in our Franklin Templeton portfolios, we do have exposure to Europe with Allan Gray and Orbis. Fortunately, we have no direct exposure to Greece at all, with either Allan Gray or Franklin Templeton.

If the Greek crisis spills over to the rest of the world, we have no intention of selling in the panic and thus trying to time the markets. If anything, a crisis in Europe would present us with an excellent buying opportunity – if so, we will contact you immediately to take advantage of that weakness on your behalf.

South Africa

We have used a similar chart before and we thought it prudent to raise it again to remind our clients that the greatest opportunities for gain are when most people are panicking or pessimistic. The South African market trades close to all-time highs and within our market there are pockets of mania and overconfidence – both of which abound at the top of bull markets – as the chart below clearly illustrates.

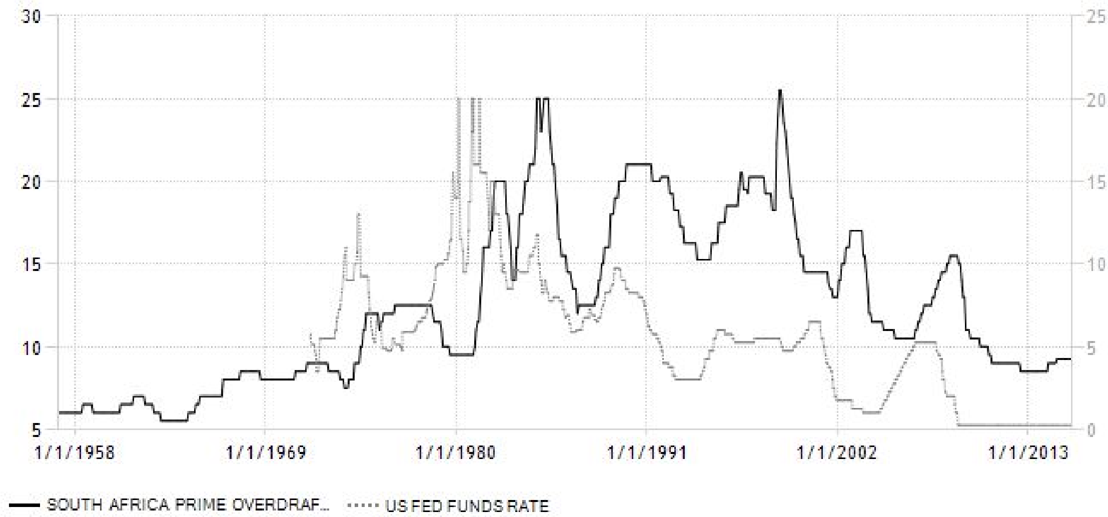


The JSE made an all-time high on April 24 this last quarter, however over the last 3 months the JSE has returned 0.27%.

In our opinion there is no real reason for the under-performance other than our market is just too expensive. Furthermore, the SA market suffered outflows this past quarter and we can only assume that global equity managers are selling SA shares because they are finding better value in cheaper regions elsewhere.

If the Greek crisis deteriorates and they default on all or part of their outstanding debt, it would almost guarantee higher interest rates globally – South Africa being no exception – as investors would demand higher interest rates to offset the risk of lending money to insolvent governments. For over-indebted South African consumers, higher interest rates would be the straw that breaks the camel's back, especially if you keep in mind the current electricity crisis, toll roads, food inflation, water, rates and taxes.

Below is a chart of both South African and US interest rates, and it's interesting to see our interest rates correlating positively with American interest rates, given a lag of a couple of months or so.



Source: tradingeconomics.com

In our last commentary, we alluded to the overconfidence in the share price of Capitec Bank - below is the latest chart depicting its movement. Capitec has now lost almost 30% of its value since we last spoke, and if it continues to track the typical Eiffel Tower pattern this share should retrace all of its gains back to R200.00 per share before bottoming out.

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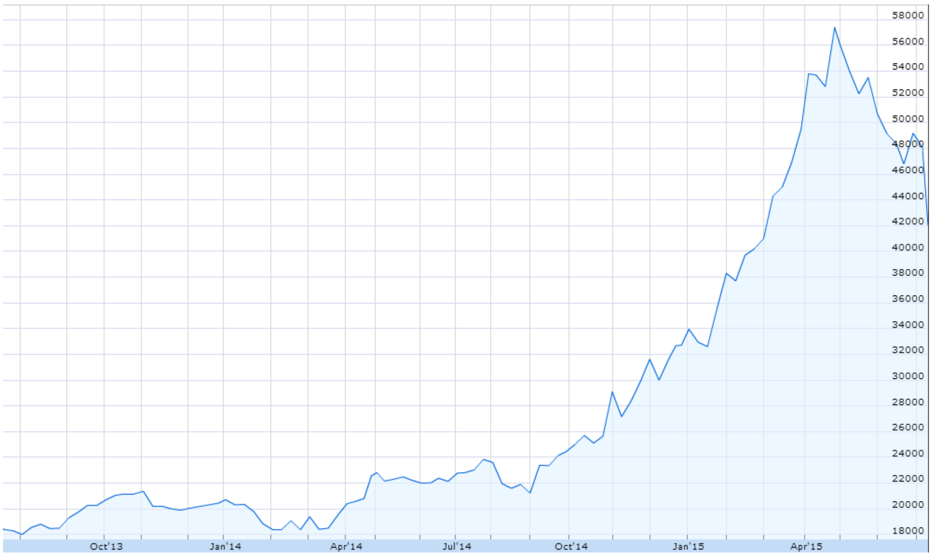

Source: Google Finance

Below is a chart of the USD/ZAR exchange rate going back 10 years. The down trend is illustrated in the channel between the red lines. As long as that channel holds – we are going to stay the course with our present advice.

Source: xe.com

We still remain extremely cautious on South Africa with a strong offshore bias for our South African clients.

Allan Gray/Orbis

In light of difficult markets, we are reasonably pleased with the performance of our Allan Gray portfolios this past quarter and this last year. It may not have felt like it, but we had a modest quarter.

Not only did our offshore Allan Gray/Orbis portfolios recover this last quarter, but even our most conservative option – the Stable Fund – has outperformed the JSE and the more aggressive Balanced and Equity Funds over the past quarter and past year. We believe this will continue.

Whereas previously a strong USD against the Rand was the only harbinger of returns, the Euro has now also rebounded 4.68% over the last three months against the Rand.

The Global Optimal Fund, a laggard over the past year, rebounded this past quarter with a 4.1% return. This underscores the importance of not constantly chasing performance, as it invariably costs you money.

There are some poor returns emanating from our market. Funds in the Resources Sector are down on average 20% over the past year, and the Investec Value fund (-16.46%) as well as the Momentum Value Fund (-25.23%) are leading the pack on the downside among the more diverse equity funds.

What pleases us most is that whilst we may have had phone calls questioning performance and concern over the volatile markets within the past three months, not a single client panicked and adjusted their portfolio which in hindsight would have cost hard earned returns.

Managing ones emotions are critical to successful investment management. If you are going to sell at the bottom of a cycle every time there is a mini-crisis and then buy back in when the markets have recovered - you are going to consistently lose money.

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Franklin Templeton

We warned it would be very bumpy, but we believe Japan, Asia and China are at the cusp of multi-year bull markets, and we are going to ride that bull, irrespective of the volatility.

We bought in Japan, China and Asia over the past 18 months when there was panic and complete despair in those markets. We thus, as the emotions chart above alludes to, maximised our opportunity for gain.

China is one of our largest holdings, and in light of the market volatility specifically in China we would like to reassure our clients that we are not invested in the more expensive and extremely volatile mainland Chinese markets. Above is a valuation chart (PE Ratios) of the Chinese markets. We are invested in the Hong Kong H Shares Index – the blue line - which clearly illustrates that these shares trade at a massive discount compared to the other Chinese shares.

Over and above Greece, we are unfortunately still been held hostage by The Federal Reserve in America, who have intimated that they will raise interest rates in September. Higher interest rates in America are generally a negative for equities, in particular for Emerging Markets, as the strengthening USD exerts upward pressure on interest rates.

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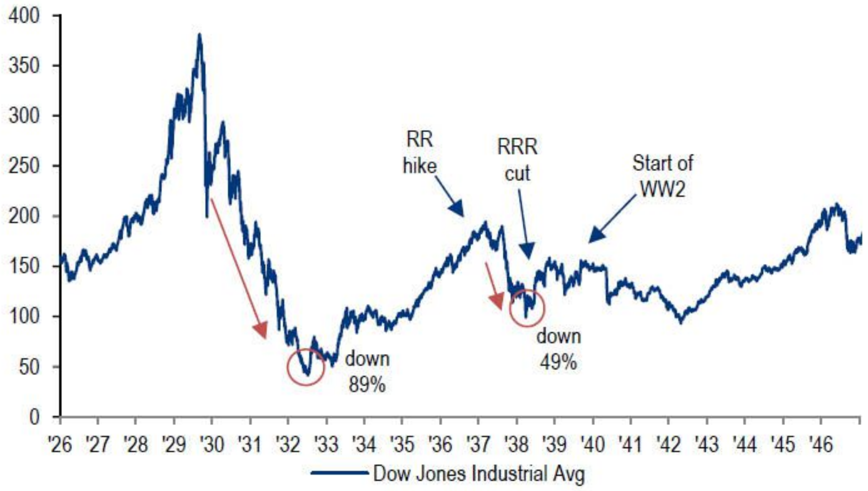
Let's look below at what happened the last time America raised interest rates after a similarly weak economic spell in 1937. The market had recovered after the Great Depression and America then raised rates only twice. The Dow Jones Industrial Index consequentially sank 49% over a 2 year period. History won't necessarily repeat itself, but it can rhyme - it is thus always valuable to study the past.

Chart 8: Dow Jones Industrial Average during the Depression Era



Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg

To conclude; we remain tentative of South Africa and recommend clients invest as much money offshore, as their appetite for volatility allows. Overseas in our USD positions we are going to hold fast with our preference for Japan, China and Asia, despite the turbulence we are experiencing – and expecting over the next couple of months.

Thank you for your continued support.

Kind Regards

Mike Carruthers

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