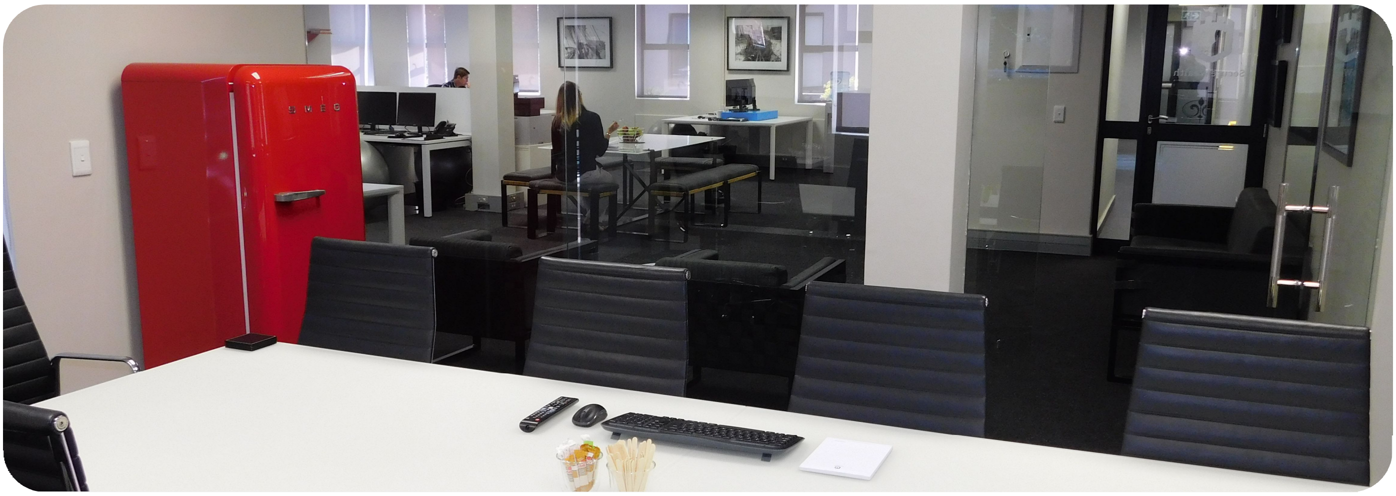

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Quarterly Commentary June 2016

"Successful investing should be more like watching paint dry or watching grass grow. If you want excitement, take $800 and go to Las Vegas." - Paul Samuelson

At a glance:

- Brexit: Britain voted to leave the European Union in a referendum on 23rd June. The Pound got crushed! In light of the vote, property funds in the UK are under severe pressure owing to massive redemptions at time of writing.
- JSE/FTSE: The JSE was up 1.23% for the quarter and is up just 0.79% over the past year.
- South African Rand: The Rand was 0.23% higher this last quarter but has lost -5.19% year to date against the USD.
- The best performing major asset class in South Africa for the quarter – local bonds.
- Allan Gray: We had a poor June – but over the quarter our largest holdings were flat.
- Coronation Portfolio Managers: The more aggressive Global Emerging Markets strategy did well in difficult global markets, and the more conservative option was negative for the quarter.
- Franklin Templeton: Our USD portfolios were stagnant this past quarter. We review our largest holding, the Templeton Global Bond Fund, a little later.

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Brexit

Against all expectations the UK voted to leave the European Union (EU) on June 23rd. The UK joined the European Economic Community (EEC), an earlier form of the EU which was then referred to as the Common Market, in 1973. More than 30 million people voted in the referendum resulting in a 71.8% turnout – higher than any turnout in any election since 1992.

Before the UK can actually leave the European Union however, it has to invoke Article 50 of the Lisbon Treaty. Once this is set in motion, the UK has two years to renegotiate all trade agreements before a formal separation takes place - an extremely complicated process.

Courtesy INET Bridge

The British Pound plunged to lows not seen since 1984. It is illustrated quite clearly on the graph above.

In addition to the vote costing British Prime Minister David Cameron his job, there has also already been a vote of no confidence in the leader of the opposition party – Jeremy Corbyn. This comes in light of Corbyn's lacklustre campaign to persuade members of the Labour Party to remain in the European Union. All in all, a very unsettling time for the UK!

Furthermore, as markets digest this news, half of all UK commercial property funds have been shuttered as investors panic and try to withdraw their capital. Simply put, there is not enough cash in these funds to meet requests and they have had to close. Property is unfortunately not a liquid investment – this is quite literally a run on the bank! When investors hear that they cannot get their money out of a particular asset class, in this case property, more and more investors tend to panic and send in withdrawal orders. In short, this results in a crisis of confidence, followed by a good old fashioned liquidity crisis!

We took advantage of the sell-off in both European and UK shares caused by Brexit by purchasing blue chip shares via Exchange Traded Funds offered in these regions for our Investec clients. There is approximately a 20-25% discount on these shares which we feel is a very good opportunity, although we would be the first to concede that things may get cheaper. Should this be the case, we will most certainly add to our positions.

Additionally, should the Pound continue to fall precipitously – over and above the current 14% depreciation against the USD – it too becomes an asset class that we will add to our portfolios.

The British Pound survived two World Wars – the odds are pretty good it will survive Brexit.

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South Africa

The most important dates to flag on your calendar in South Africa over the next 6 months are:

- The August 3rd municipal elections
- Another credit rating decision by or on December 2nd from the world's major rating agencies.

Internationally, the American election occurs on November 8th after a vicious battle between two divisive and unpopular candidates - Donald Trump and Hillary Clinton. The adverse volatility these two create could certainly have ripple effects on all markets, including South Africa.

Meanwhile, the Rand continues to fluctuate wildly, reacting to both local and international developments. Our phones are busy – clients continue to enquire about the volatility of their investments. We would like to appeal to all clients to try and take the short term movements in their portfolios in their stride, since it is natural after a fantastic year last year that markets and currencies would take a breather.

Whilst there are real pockets of value in the South African market, we stand by our belief that with the upcoming municipal elections and an inevitable credit rating downgrade at the end of the year, our currency and economy are still vulnerable.

Furthermore, what of Brexit's long term consequences for South Africa? We have no idea, but we cannot believe it will be a positive for an economy already under pressure.

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Courtesy INET Bridge

Above is a chart of our two largest holdings versus the Top 40 shares in South Africa. We own the Allan Gray Global Optimal Fund of Funds (in purple) and the Allan Gray Stable Fund (in green). The red line is the price of the Top 40 shares in South Africa.

What is striking is the volatility. Look at how prices are jumping around! That is what is causing consternation amongst our clients and us. We went through a similar patch in 2014, which is evident if you cast your eye back along the purple line - just before we had an excellent year in 2015.

We are going to stay the course with our advice and we are asking clients to hold tight with the volatility at the moment. It will eventually pass.

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Courtesy INET Bridge

The ZAR/USD exchange rate is depicted above and it is clear that after a sustained decline the Rand is rebounding against the USD. We met with one of the most senior asset managers at Allan Gray recently and he made a very pointed comment: South Africa makes up approximately 1% of global market capitalisation.

This begs the question that if you do not need a monthly income in South African Rands – then there is no reason why you should not have the bulk of your assets overseas.

As a South African without a significant portion of your investable capital overseas, internationally you have become 25% poorer in the last 18 months.

We therefore still believe the medium term risks rest with our currency and our economy.

Global Markets

"In investing, what is comfortable is rarely profitable." - Robert Arnott

Courtesy INET Bridge

Above is the price action of our largest holding overseas – the Templeton Global Bond Fund. We also have exposure to the cheaper Emerging Markets – primarily China, India, South Korea and Taiwan.

Once again the volatility is quite evident - the bulk of our purchases took place in the early 2016, and we are hoping we have seen the worst. The fund has USD22 billion invested in it globally. It is managed by one of the best bond managers in the world, Dr Michael Hasenstab, who has a PhD in Economics.

We have alluded to this before – the overseas markets are the most challenging we have ever seen. If you study the chart, it is quite obvious that over a 4-year period the fund has gone sideways. Here is a great fund manager with all with all the research capabilities of Franklin Templeton (one of the largest Asset Managers in the world) – and they haven't managed a USD return in 4 years. It is definitely not easy to garner a USD return at the moment.

Dr Hasenstab's opinion is quite clear:

1. Concerns for a systemic financial crisis across emerging markets appear exaggerated
2. He expects the ECB and the Bank of Japan to continue easing monetary policy whilst the Federal Reserve in America trends towards a tightening policy
3. Markets have not appropriately priced in the potential for further US rate hikes - he thus favours the USD against the Euro and the Japanese Yen
4. Most commodity exporters and emerging markets with poor macroeconomic fundamentals remain vulnerable – he specifically mentions South Africa
5. Despite the concerns in China, he does not see a hard landing.

We know there are concerns out there at the moment. However, we also believe that every portfolio should have some risk attached to it – just in case those concerns do not materialise.

We are gradually increasing equity exposure to select, and preferably cheap, beaten-down markets. This is evident in our decision to buy into Europe and the UK after the Brexit result caused a mini-panic. We are not going to call the bottom in these markets – but if you are buying quality companies with a good dividend history whilst in a very low interest rate environment overseas, at some stage we believe this strategy will pay dividends.

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Thank you once again for the patience you afford us. We in turn can assure you that every effort is made to preserve your capital and make prudent investment decisions that produce acceptable returns.

Please do not hesitate to contact us with if you have any questions or queries.

Kind Regards

Mike Carruthers