

Quarterly Commentary

December 2017

*"There is nothing riskier than the widespread perception there is no risk"* Howard Marks



A difficult year for conservative South African investors with significant overseas exposure (ourselves) – and exacerbated if you had any exposure to Steinhoff, which for us was unsubstantial. I for one am very pleased that 2017 is behind us, due to all the uncertainty;

- Steinhoff – South Africa’s largest ever corporate casualty.
- President Zuma, free higher education for all, and the ANC elective conference in December.
- The Rand and the Turkish Lira, were the world’s most volatile currencies tracked by Bloomberg.
- South Africa was downgraded – more to come in 2018?
- President Trump and Kim Jong-un.
- Allan Gray/Orbis restricted or closed their offshore funds in all of their products.
- For business owners and residents in the Western Cape, an unprecedented drought showing little sign of relenting.

The Rand surged after the election of Cyril Ramaphosa (CR). We were expecting the Rand to rebound if he won – but to be honest, not as much as it did. We now feel most of the good news is priced into the currency. It would be a mistake to believe that the value of the Rand is determined by local factors alone – amongst other global developments, US interest rates are rising and at some stage that could have a serious impact on the Rand.

Despite the pain it caused our portfolios, we are infinitely more confident with CR as President as we would have been with Dr Nkosazana Dlamini - Zuma. Yet the ANC is now probably assured of power for the foreseeable future. A healthy democracy thrives on strong interchangeable political parties who compete for power.

## Steinhoff



The greatest fear we have – is making investment decisions that results in the permanent loss of your capital. Steinhoff is unfortunately a perfect example. The primary risks of investing there are not temporary price fluctuations (volatility), like the Rand recently.

We had inconsequential exposure to Steinhoff. A few of our Investec Wealth clients had a minor position in their share portfolios. Our local Allan Gray funds only had 0.1% exposure – which is minuscule. A couple of our retirement solutions with Coronation had an insignificant position. Our offshore funds had no exposure whatsoever.

Steinhoff - 5 years



Courtesy of Infront

Allow us to place the Steinhoff losses into context: Allan Gray has approximately R300 billion housed in 9 funds in a myriad of different products. That R300 billion has been accrued over a 19 year period and includes all the contributions made by thousands of investors, and also the compounded annual returns they have generated since 1999. The total losses to investors in the Steinhoff debacle also amount to approximately R300 billion. The losses are thus staggering.

## Allan Gray



Allan Gray closed their offshore funds in all their products on December the 15<sup>th</sup>. We can only assume that hundreds of investors transferred money into overseas funds in anticipation of the elective result, thus eliminating any remaining capacity AG had. Those investors immediately took a short term knock as the Rand surged. Conversely, these losses are offset by the security that their money is in overseas accounts which are no longer accessible to new investors.

Fund	Risk	ZAR Return - 1 Year (%)	USD Return - 1 Year (%)
AG Stable Fund	Low - Medium	9.60	N/A
AG Global Optimal Fund of Funds	Low Offshore	-0.60	10.60
AG Global Fund of Funds	Medium – High	7.00	19.00
Coronation Global Capital Feeder Fund	Low Offshore	4.90*	6.70*
Coronation Global Emerging Markets	High - Aggressive	34.8*	37.4*

\* As of 30<sup>th</sup> November

Despite the resurgent Rand, if you study the table above, it is not all doom and gloom. Our largest holding, the low risk Global Optimal Fund of Funds realised an **USD 10.60%** return for the year. If one considers that the average Global Equity Fund has given a **USD 5.4%** p/a over the past 25 years – we are reasonably pleased. The Coronation Global Capital Feeder Plus fund also had a very acceptable USD return for the year of **6.70%**, but obviously the strong Rand affected its performance in local terms.

Our most aggressive recommendation (Coronation Global Emerging Markets Fund) shot the lights out – USD 37.40%. We have reduced exposure to this fund in line with our concerns regarding global markets which we expand on below.

Allan Gray Stable Fund, our largest local fund, realised a ZAR 9.60% return.

## Global Stock Markets



Global markets are euphoric. They have just had their best start to a year since 1987. American markets have only ever been more expensive on one occasion including 1929 (see chart below). Margin debt (money borrowed to buy shares) is at a record high. Sentiment and confidence levels tracking markets are also at record highs. Measures of volatility and fear have never been lower. Joe Public is all in, as he tends to buy the most at the top (red star) and the least at the bottom (green star). Retail investors have the most shares (risk) in their portfolios since the 2000 bubble. Exchange Traded Funds or passive investing (essentially buying the most expensive stocks) is now all the rage. Only one other time (1959) have American markets gone longer without a 5% correction. The most lucrative time to buy shares or to be fully invested is clearly when the market is cheap - not at the moment.

S&P 500 Shiller P/E Ratio



We field phone calls every day from folk who have never had an interest in the market now wanting to buy Bitcoin. Ripple, a cryptocurrency and an alternative to Bitcoin, was up **35000%** (that is thirty five thousand percent) in 2017 – and the CEO Chris Larsen briefly became the 5<sup>th</sup> wealthiest man in the world.

Personally, I have not seen this feverish investor behaviour since the Internet bubble of 2000.

And Janet Yellen the outgoing chairlady of the Federal Reserve in America, recently stated that “*we would never see another financial crisis in our lifetimes*”.

**The above is extremely concerning** - if you really do your homework on the markets leading up to the 2000 and 2007 crises – the conditions we are experiencing at the moment are very similar:

1. Earnings are strong.
2. Economic growth is improving.
3. The Federal Reserve is hiking interest rates.
4. Investor and consumer confidence is at all-time highs.
5. Investors are throwing caution to the wind – they have absolutely no fear of losing money.

In times like these, it is incredibly demanding being cautious with your money. Clients and friends look at you as if you have completely lost your mind. FOMO, the fear of missing out, and the peer pressure to “jump on board” is enormous.

When we study the speculative environment raging in the markets, we feel it our responsibility to be defensive with your money. To preserve your capital. If we are going to put your money at risk – we want or need a margin of safety. And that does not exist at the moment. In our opinion the downside risks far, far outweigh the rewards in these markets.

The world’s Central Banks are currently taking away the punch bowl that has created this frenzy: *cheap money!* The Federal Reserve is also reversing its Quantitative Easing (QE) programme in favour of gradually reducing its balance sheet.

We believe the most important chart in the world is the US Treasury 10-year interest rate. The 10-year rate is critical as it affects almost every single financial market in the world. See chart below.

The increase in the 10-year rate coincides with intensifying inflation. The US labour markets are the tightest in a generation and China and the Arab states are trimming their US treasury purchases.

### US Treasury – 10 Year



*Courtesy of Bloomberg*

Some of the world's savviest bond managers (including Dr Michael Hasenstab of Franklin Templeton, and Bill Gross of Janus Henderson) believe the 30-year-old bond bull market in America is over and considerably higher interest rates are imminent.

And the overly-confident market we allude to above – is just not prepared for that eventuality.

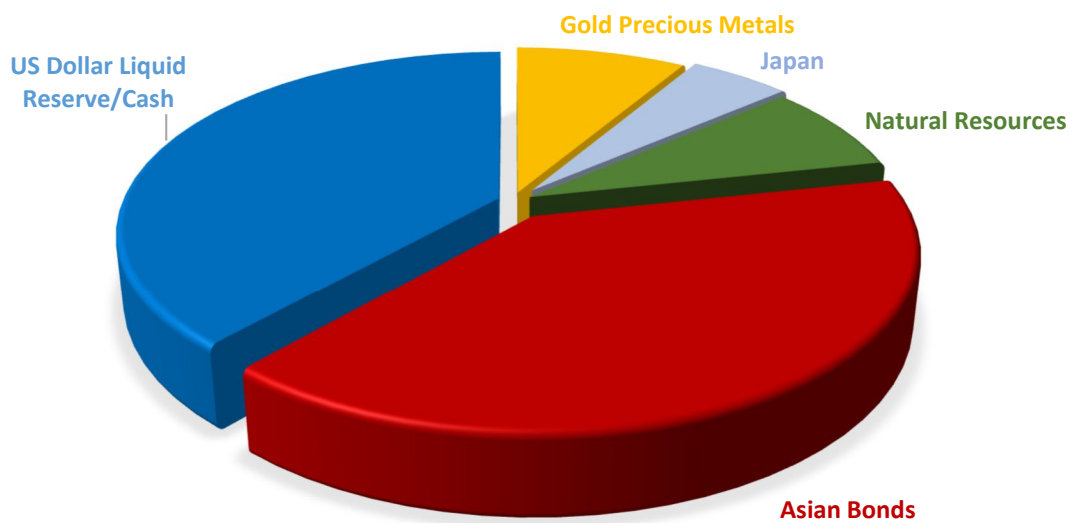
## Franklin Templeton



Our Franklin Templeton USD portfolios are trading at all-time highs. Whilst we have reduced risk in the portfolios – we have not eliminated risk completely. We are overweight low risk Asian short-dated bonds and their currencies. USD cash, Japan equities (Toyota, Honda and Softbank), beaten-down global energy shares (Exxon Mobil, BP and Royal Dutch Shell) and gold and precious metals stocks (Newcrest and AngloGold Ashanti) make up the balance of the portfolios. We would like substantial exposure to Emerging Markets – but not with the concerns we harbour at present.

South Africans do not earn or generate US Dollars every month – and they are subject to stringent Exchange Control regulations. Therefore, permanent loss of US Dollars for a South African investor would be a catastrophe. We manage these accounts with this always in mind.

Below is a standard Franklin Templeton portfolio. They differ from client to client.



## Investec Wealth and Investment



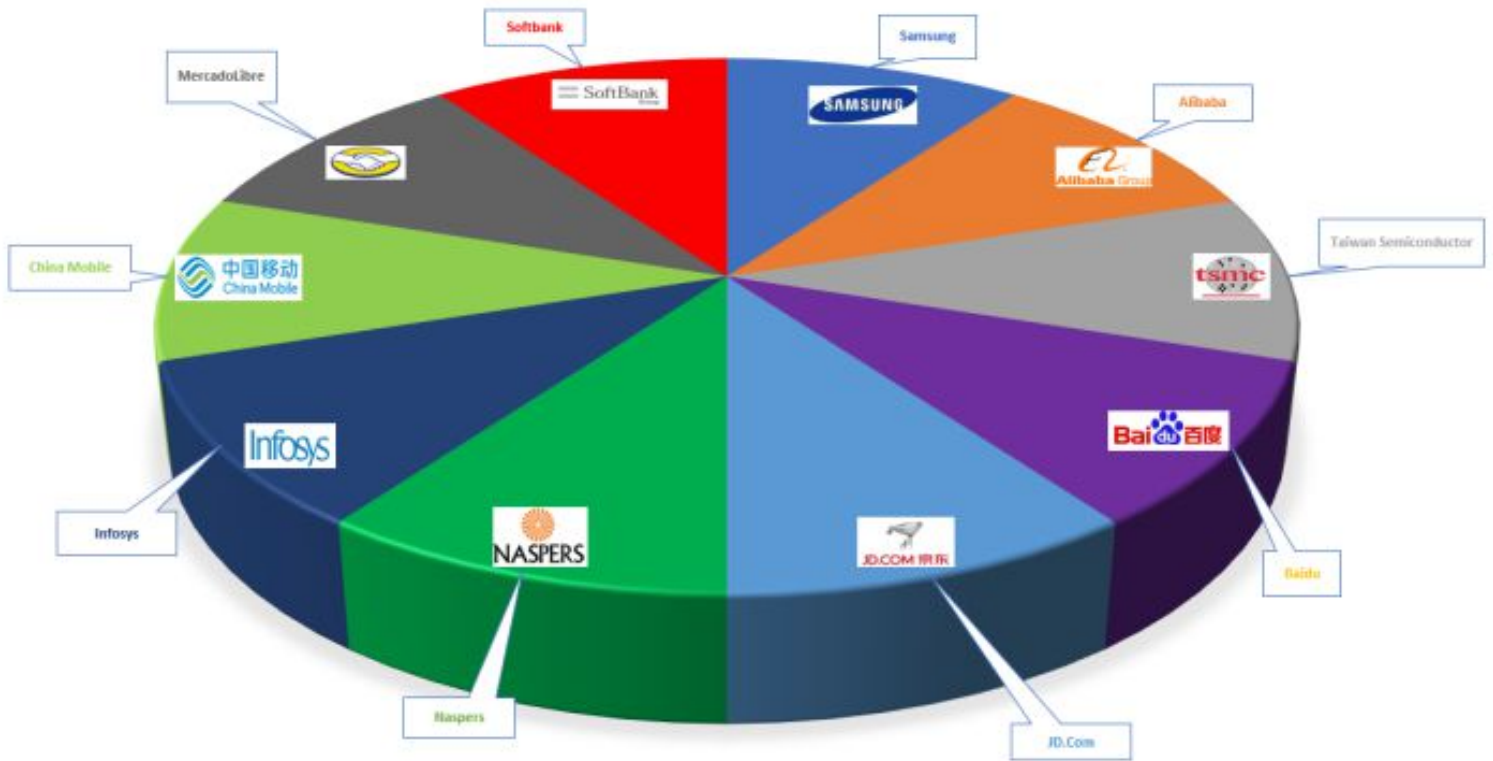
Our private share portfolios with Investec are overweight Emerging Market Technology shares, which is aggressive by our standards. To balance the portfolios, we segment that position where possible, with value shares paying healthy annual dividends both here in South Africa and overseas. For most clients we are holding approximately 25 - 50% in cash. If and when the market offers a compelling opportunity, we will increase that equity exposure immediately. See the shares we are recommending in the addendum.

We would like to thank you for your patience and ongoing support. All the best for 2018.

Mike Carruthers

Addendum: Recommended Investec Share Portfolios

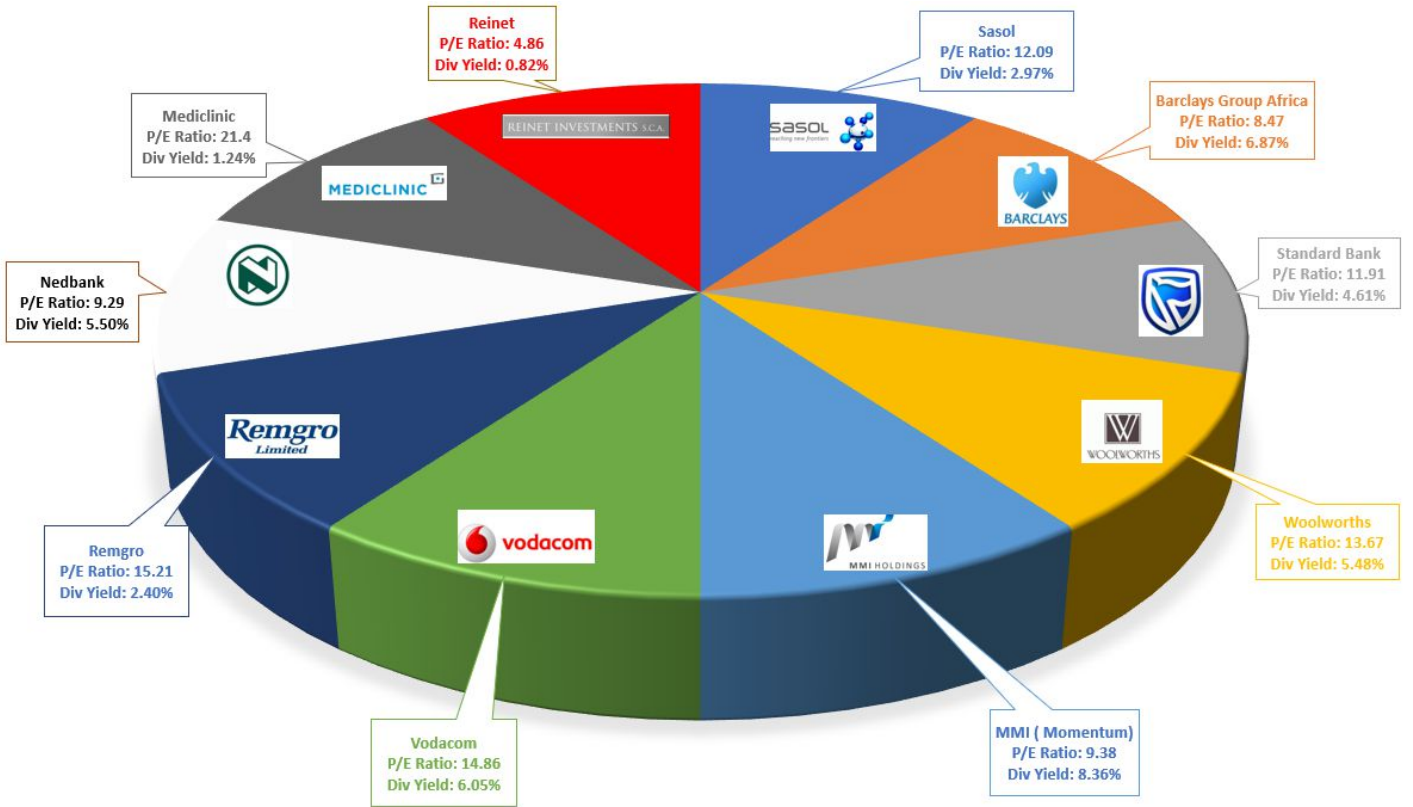
Figure 1: Emerging Market Technology Shares



<p><b>Samsung:</b> One of the largest multinational conglomerate tech companies in the world – revenue of \$350 billion and close to 500 000 employees.</p> <p><b>Alibaba:</b> The world’s largest retailer, having surpassed Walmart in April 2016.</p> <p><b>Softbank:</b> USD79 billion annual turnover – seventh largest company in Japan. One of the most diversified Asian technology giants in the world – has a very large shareholding in Alibaba above.</p> <p><b>Taiwan Semi-Conductor:</b> World’s largest dedicated and independent semiconductor foundry.</p> <p><b>Infosys:</b> The second-largest Indian IT services company.</p>	<p><b>MercadoLibre:</b> Is the largest ecommerce company in South America with 4000 employees.</p> <p><b>Baidu:</b> The Google of China. 45000 employees and one of the premier AI (artificial Intelligence) companies in the world. Our largest holding for our clients and ourselves.</p> <p><b>JD.com:</b> One of the two largest online retailers in China by transaction volume and revenue with 237 million active customer accounts.</p> <p><b>China Mobile:</b> Presently the world’s largest mobile telecommunications company by market capitalization.</p> <p><b>Naspers:</b> Owns 34% of the largest Chinese technology company in the world – Tencent. And has exposure to other exciting global technology companies not available to South African investors.</p>
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**Figure 2: South African Shares**



**Figure 3: Offshore Blue Chip Shares**

