INVESTMENT RESEARCH AND STRATEGY REPORT

AUTUMN 2016

PSG Wealth

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Executive summary

Growing Pains

From the changing nature of Remgro and global fund selections to a shifting Chinese economy – all indicate growing pains from previously successful models to new ways of creating sustainable growth and wealth. In some instances these growth spurts can take place over a financial year; in other instances only over decades. One thing is sure, adapting to the changes they bring is the best way to manage your wealth.

In our autumn edition of the PSG Wealth Investment Research & Strategy Report, our contributors have focused on some of the growing pains seen in the global economy. Franco Pretorius, Head of Direct Security Research, talks about the changing nature of Remgro. Remgro is a diversified investment holding company with investments in listed and unlisted companies, focused on the financial and industrial sector of South Africa. The group has consistently managed to adapt to the changing environment throughout its 68-year history. Its investment philosophy – of being a patient investor in defensive industries with business models that are supported by strong cash generation and entrepreneurial management teams – has translated into a long history of market-beating returns, generated in a cost-effective manner. Companies like Discovery, FirstRand and MediClinic International form part of Remgro's stable.

In our property commentary section, Jan Kriel, one of our equity analysts, looked at Hyprop and Redefine, which have become the latest real estate investment trusts (REITs) to join the trend of local REITs flocking towards European real estate. In early February, Hyprop made its first foray into Eastern Europe after acquiring two shopping malls in Serbia and Montenegro for a total purchase consideration of €203 million. Then in early March, Redefine made a bold move into Poland by acquiring a 75% stake in Echo Prime Properties, which consists of 18 high-yielding commercial properties worth €1.2 billion. The deal marks one of South Africa's largest real estate transactions to date. This will expand Redefine's offshore exposure beyond that of the UK and Australia, where it owns significant stakes in Redefine International (30.1%) and Cromwell (25.6%).

Our senior fund analysts, Henko Roos and Johan Pyper, have turned their attentions to changes in one of our global fund structures and the impact of exchange rate fluctuations on our domestic solutions. Henko explains amendments in the PSG Wealth Global FoF after a trip the fund management team took to Boston in the US. He explains the reasoning behind the inclusions of the three sought-after global managers, as well as the general due diligence process followed by the PSG Wealth investment division. Read his article on page 22 for a further discussion on the concept of 'offshore for offshore' and the benefits of utilising global names in a solution.

Johan makes it clear that there is a high degree of uncertainty about the immediate future of the rand. The weak rand may have already discounted most of the bad news, but there are also various factors which could lead to a stronger rand. The data examined in this piece support the view of the PSG Wealth investment division that it's very important to have offshore exposure in investment portfolios to participate in diversification benefits. The benefit of diversification relates to quality offshore assets that are not available in local markets, at favourable prices.

In the in-depth discussion on the results of our first poll question ("Will emerging market assets/commodity prices bottom in 2016?") our investment writer, Jinine Botha considers the influence of Chinese economic policies. The prices of commodities follow a cyclical pattern of supply and demand. And although China has represented much of the demand-side in the past few decades, the supply-side could also influence the price of these emerging market assets. The PSG Wealth investment division believes that the super commodity cycle previously fuelled by China is over, and will not be seen again. This does not mean that the demand for commodities in other markets, such as India or South America, will disappear. However, the hunger for commodities in these markets will not be as fierce as in China, and will most likely present itself at a slower pace over the next 50 years. We also view China's economic transformation from a manufacturing-based economy to a consumption-based economy as more sustainable in the long run, albeit at a slower rate.

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In our previous quarterly review we mentioned that the South African forward rate (FRA) curve was pricing in rate hikes totalling 0.75% over the next two Monetary Policy Committee (MPC) meetings. The last MPC meeting was concluded on 17 March and these estimates were spot on, as the MPC raised rates by 50 basis points in January and a further 25 basis points in March. With inflation statistics currently surpassing earlier forecasts, we expect a further interest rate hike over the coming quarter. The MPC will likely increase interest rates by a further 25 basis points on 19 May. At this stage money market FRAs indicate that a 3-month fixed deposit could yield 7.8% in nine months' time. This implies that the money market is expecting rate increases of about 0.75% over the same period. This validates our view that cash is becoming an increasingly appetising investment option for our multi-asset funds.

I have also given my own insights into prevailing economic and financial market conditions, as well as our tactical view on wealth management.

Remember to follow this link to take part in our new survey on the digital wave hitting the financial services sector.

With economies and companies around the world going through growing pains to adapt to a changing environment, as wealth managers we feel it is crucial, especially now, to stick to three core investment beliefs: managing expectations, adopting appropriate investment horizons and diversification.

We hope you enjoy the read. Please feel free to send us any feedback you might have – we always look forward to hearing from you.

Regards,

Adriaan Pask
Chief Investment Officer

How to navigate this document

You can navigate this document in two ways.

- **Links in table of contents:**
  Simply go to the table of contents page. Click on the headline of the article you want to read and enjoy.
- **Links on each page:**
  At the bottom of each page are three buttons/links. Clicking on BACK will take you to the previous page in the document you were reading. The CONTENT button will take you back to the table of contents page where all the headlines of the articles are linked to their respective piece in the report. While the NEXT button will take you to the next page of the article you were reading.

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Economic commentary

The host of economic challenges South Africa faced coming into 2016 deepened further during the first three months of the year. The economy barely grew in the last quarter of 2015. Growth for the whole year came in at 1.3%, a deceleration greater than the expansion seen in 2014. Last year's slowdown reflected contractions in nearly all sectors of the economy, with agriculture recording a doubled-digit decrease. The latest economic data shows that the economy failed to gain momentum during the first quarter of this year.

Economic indicators - as at 31 March 2016

	2016			2015								
	MCH	FEB	JAN	DEC	NOV	OCT	SEP	AUG	JUL	JUN	MAY	APR
Repo (%)	7.00	6.75	6.75	6.25	6.25	6.00	6.00	6.00	6.00	5.75	5.75	5.75
Prime (%)	10.50	10.25	10.25	9.75	9.75	9.50	9.50	9.50	9.50	9.25	9.25	9.25
FRA 9x12 (%)	7.80	8.10	7.79	8.17	7.21	6.96	7.06	7.08	7.01	6.93	6.99	6.84
Inflation (%)	6.3	7.00	6.20	5.20	4.80	4.70	4.60	4.60	5.00	4.70	4.60	4.50
ISM Index (%)	51.00	48.70	41.00	46.70	50.00	52.00	52.00	49.30	46.40	46.40	50.30	44.00
Unemployment (%)	*			24.5			25.5			25.0		
GDP Growth (Y/Y) (%)	*			0.6			1.0			1.2		
Current Account (% of GDP)	*			-5.1			-4.3			-3.1		

**Sources: iNet, Stats SA, SARB

Slowing gross domestic product (GDP) growth

South African output growth has been slowing steadily, according to recent data released by the South African Reserve Bank (SARB). The most recent forecast suggests GDP growth of 0.8% for 2016, down from 1.5% as projected in November 2015 and from 2.9% projected a year before that. Forecasts for 2017 have also declined, with the latest indicating 1.4% growth for next year and 1.8% in 2018. In comparison, South Africa averaged 3% annual growth since 1994.

In the recent past, disappointing growth outcomes have been traceable to specific shocks, including strikes, electricity shortages and drought. However the outlook now indicates more drawn-out sources of weakness. Consumer and business confidence is low. The SARB's leading indicator of business activity trended lower throughout 2015 and fell further in early 2016. Net exports face headwinds from declining commodity prices and slowing world trade growth. Government is also entering a period of intensified fiscal consolidation.

Households remain under pressure, burdened by debt and high levels of unemployment, among other factors. Despite slowing GDP growth, inflation in South Africa has begun to accelerate again, after a year of relatively moderate price increases. Inflation in 2015 averaged 4.6%, between the 3% to 6% target range, mostly due to sharply lower world oil prices. Inflation has since rebounded to 6.2% in January and 7% in February, the highest rate in the post-crisis period. It is expected to average well over 6% in both 2016 and 2017.

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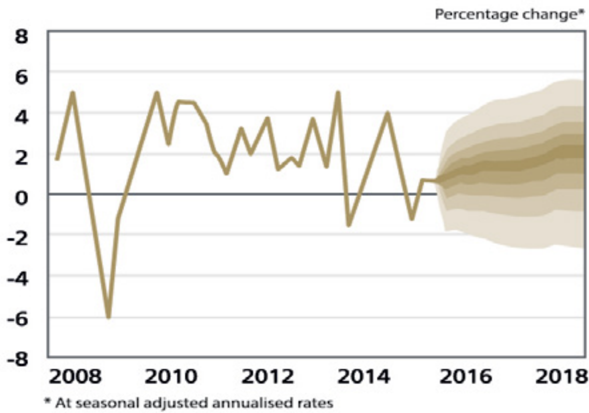
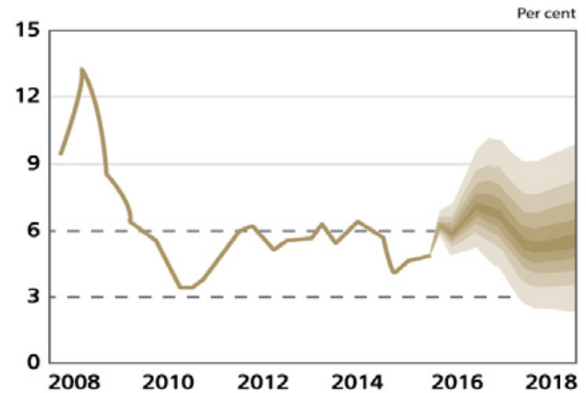
Economic commentary

Real GDP growth forecast



Source: South African Reserve Bank

Targeted inflation forecast



- - - - Inflation target range
* CPIX for metropolitan and other urban areas until the end of 2008; CPI for all urban areas thereafter

Source: South African Reserve Bank

According to the SARB, monetary policy in South Africa confronts the prospect of a prolonged breach of the inflation target, even as growth trends lower. This rate has now been raised by a total of two percentage points since January 2014, when forecasts for inflation first began showing significant risks of sustained target breaches. During the previous quarterly review we communicated that we expected interest rates to increase by 0.75% over the quarter, and that is exactly what materialised. For the coming quarter we expect another 25bps increase in May and a further 25bps hike in July. This is slightly less than what the South African forward rate curve is pricing in. The latter is pricing in a total increase of 80bps.

Recent shifts in financial market volatility have, according to the SARB, been sufficiently large and lasting to materially affect South Africa's economic trajectory. The weakening of the rand is of particular significance for monetary policy. Although the rand appreciated against other major currencies during the first quarter of 2016, it is still crawling back from the sovereign knocks it received at the end of 2015. The rand traded at its best levels this year in April after the Constitutional Court's decision on President Jacob Zuma's Nkandla upgrades, a smaller-than-expected South African trade deficit and a weaker greenback.

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Economic commentary

Manufacturing PMI

Some positive signals do, however, exist. The manufacturing PMI advanced to 50.50 in March, higher than market expectations of 48.00. In the previous quarterly report we indicated that manufacturing PMI numbers were signalling the increasing likelihood of a local economic recession. Current numbers indicate that this might have been prevented in the short term.

Developing economy manufacturing PMIs

Country	Last	Previous	Change	Highest	Lowest
South Africa	50.50	47.10	3.40	64.20	34.20
China	49.70	48.00	1.70	52.30	47.20
France	49.60	50.20	-0.60	57.50	42.70
South Korea	49.50	48.70	0.80	52.60	45.70
Turkey	49.20	50.30	-1.10	55.00	48.00
Japan	49.10	50.10	-1.00	56.20	29.60
Greece	49.00	48.40	0.60	51.30	30.20
Singapore	48.50	49.00	-0.50	51.90	48.30
Russia	48.30	49.30	-1.00	53.20	47.60
Egypt	48.10	48.00	0.10	52.50	37.10
Norway	46.80	48.40	-1.60	64.60	34.80
Hong Kong	46.40	46.10	0.30	53.30	44.40
Brazil	46.00	44.50	1.50	53.20	43.80

Large Economies

Members of the EU

BRICS countries

Source: PSG Wealth investment division

Current account deficit

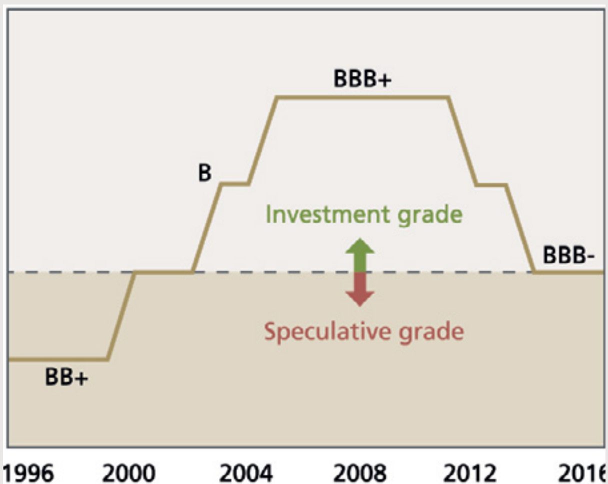
The 2016 budget presented in February showed that the government would aim to follow a fiscal consolidation path so that the fiscal deficit shrinks faster than what was projected in October last year. According to the budget this is expected to be achieved by cutting public expenditure and increasing tax revenues.

PSG Wealth

Economic commentary

South Africa's sovereign credit rating and downgrade implications

S&P sovereign ratings for SA



Source: Bloomberg

South Africa's foreign currency debt is still rated as investment grade by all three major rating agencies. Its ratings from two of the three major agencies, Standard & Poor's (S&P) and Fitch, are just one level above speculative grade ('junk' status). The Moody's rating is two levels above speculative grade. Local currency debt ratings are one notch higher for Fitch and S&P, whereas the Moody's rating is the same for both local and foreign-currency debt. Rating agencies use finely calibrated scales to express risk. Moody's, for instance, has 27 separate ratings, which are further qualified by descriptions of the outlook ('positive', 'stable' or 'negative'). For all this nuance, however, one of the most important verdicts is simply binary: is an entity investment grade or not? This matters partly because lenders require additional compensation for funding riskier borrowers, and partly because many large financial institutions such as pension funds are obliged to hold only investment-grade assets. Evidence confirms that countries with investment-grade ratings have lower borrowing costs than their speculative grade peers. Data shows that a downgrade below investment grade is likely to increase short-term rates by 80 basis points. Long-term bond yields would be expected to move more, rising by 104 basis points. Higher long-term borrowing costs would have a variety of negative effects. Government would have to allocate more spending towards debt-service costs. Because corporate borrowing costs are linked to the sovereign rating, the private sector would also be affected, raising the costs of investment. Furthermore, the rand is likely to depreciate against major traded currencies should foreign investors offload their sub-investment grade holdings. Were this to occur, it would likely exacerbate inflationary pressures in the economy.

Source: South African Reserve Bank Monthly Policy Review April 2016.

The bad news is therefore that the outlook for the domestic economy is not great. That said, market sentiment is very low and is pricing in a lot of bad news already. This does provide investors with an opportunity, especially when all the negative sentiment does not materialise. More realistically, however, prices generally seem to be compensating investors for the prevailing risks.

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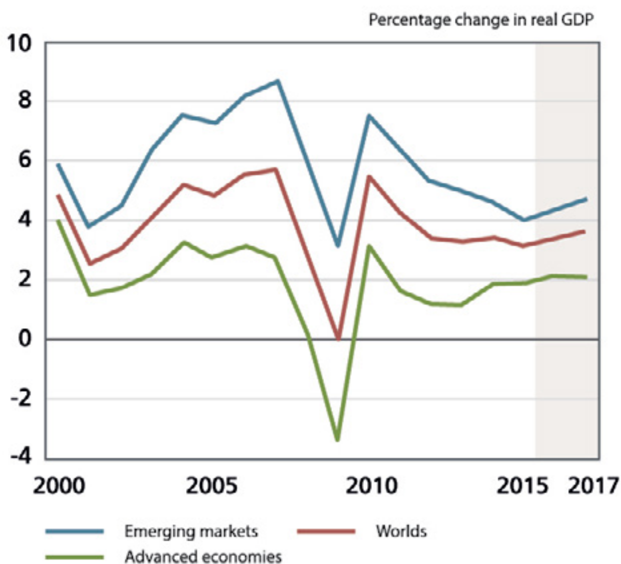
Global

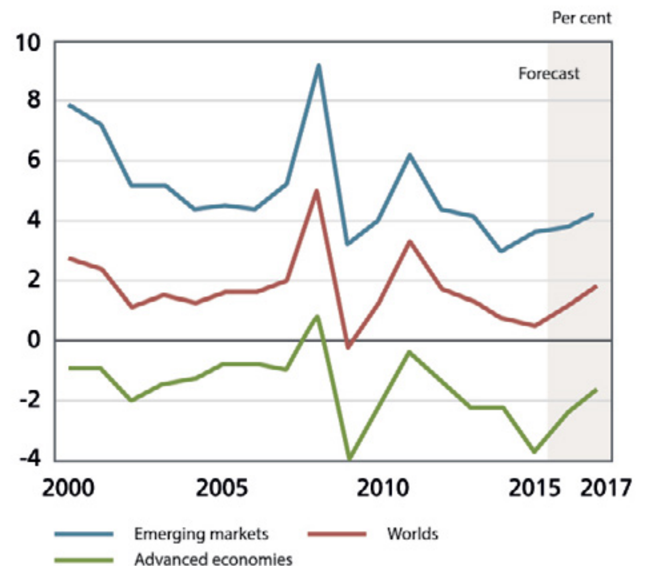
Eight years on from the financial crisis and the recovery in global growth continues to disappoint. The emerging market growth story has faded. China's economy has slowed and commodity exporters have decelerated, with some emerging markets falling into recession. Among advanced economies, the US has achieved a relatively robust recovery. By contrast, the euro area and Japan have stagnated. World inflation is at long-term lows, with only a subset of emerging markets troubled by excessively high inflation.

World GDP growth since 2000



Source: International Monetary Fund

World inflation since 2000



Source: International Monetary Fund

The International Monetary Fund (IMF) warned in April that the world economy is increasingly at risk of stalling, as it once again cut its forecast for global growth prospects. The IMF said it was forced to downgrade its growth forecast for this year to 3.2%, down by 0.2 percentage points from its projection issued in January. The fund said that China's slowdown and weak commodity prices are taking a higher toll on emerging markets than expected and rich countries are still struggling to escape the legacies of the financial crisis. The downward revision is the fourth straight cut in a year, putting world economic growth just a hair over last year's 3.1% and only marginally above the 3% rate the IMF previously considered a technical recession globally.

Recessions in Russia and Brazil are proving to be deeper and longer than the IMF anticipated after political problems compounded the effects of a plunge in commodity prices. Dozens of other oil exporters—from Venezuela to Canada, Saudi Arabia to Nigeria—are also facing sharp slowdowns.

Economic commentary

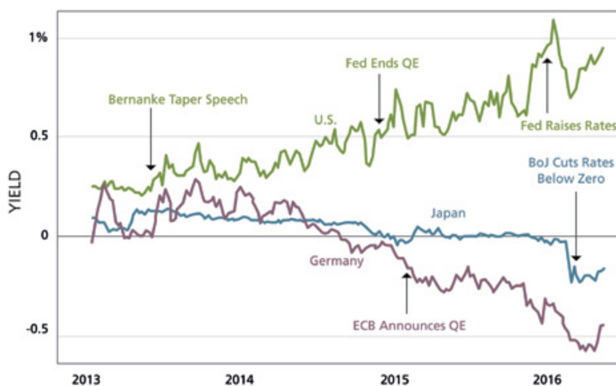
US

Wall Street's rocky start to 2016, amid concerns over the global economy, has been followed by a sharp rebound starting in mid-February. Stocks have steadied in April and the S&P 500 is now positive for 2016.

The recovery of one of the US stock markets shows that the US economy has enjoyed a relatively substantial recovery. Unemployment has fallen from 10% of the workforce to less than 5%, with around 13.5 million net jobs added since 2010. GDP growth has accelerated over the past three years to 2.4% in 2015 and is forecast to continue above 2% in 2016 and 2017. Nonetheless, markets are heavily discounting the Federal Reserve's own guidance on its policy rate, anticipating a lower level for the federal funds rate over the next three years than suggested by the most dovish forecast in the Fed's initial statements. The US dollar continues to be very strong, having appreciated more in the run-up to this hiking cycle than in any previous upward cycle in recent history.

Dealing with divergence

Two-year government bond yields 2013-2016



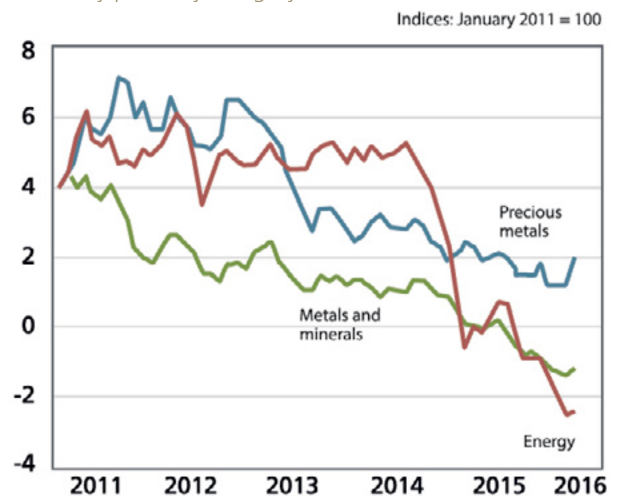
Source: BlackRock Investment and Thomson Reuters, March 2016

The path of two-year bond yields illustrates the divergence in monetary policy that has been a market theme since 2014. This has sparked the persistent appreciation in the US dollar. Data from Blackrock shows that yields have steadily climbed in the US and declined in the Eurozone and (to a lesser extent) Japan. (See chart above.)

China

The IMF upgraded China's growth forecast this year by 0.2 percentage points to 6.5%, as the service sector compensated for a downturn in manufacturing. However, the country's deceleration continues to hit trade partners around the world. Jitters about the fate of the world's second-largest economy have roiled global markets in the past year and first quarter of 2016.

Commodity prices by category



Source: World Bank

China's economy grew by 6.7% in the first quarter, the slowest since 2009, while showing signs of a promising recovery in March. Moody's is forecasting that Chinese GDP will come in at 6.3% for 2016, and will shrink further in 2017. This rating agency expects the slowdown to be mostly concentrated within the heavy industry (manufacturing) and importing sectors. Chinese debt levels have become the latest concern, with some sources citing debt levels of around 250% of GDP. Even though monetary policy is accommodative, credit conditions are tight and a large number of manufacturing firms are only managing to survive on lines of cheap credit from the banks. These conditions raise concerns around the stability of the banking sector during times when their customers are not earning so much money.

Although China's deceleration is the most important aspect of the emerging market slowdown, its growth is still so rapid that the performance of the emerging

Economic commentary

markets category is distinctly worse with China excluded.

Two of China's major emerging market peers, Brazil and Russia, are in recessions that have become deeper and more protracted than previously anticipated. Russia's economy declined by nearly 4% in 2015 and is expected to contract by another 1% this year. Brazilian output shrunk by 3.8% in 2015 and the latest forecasts suggest 2016 will be similar. Even though commodity prices started to pick up in the first quarter of this year, South Africa has not been able to avoid the ripple effect created by its largest trading partner.

European Union (EU)

The economic outlook in the EU continues to improve. However, policy differences about the inflow of refugees into the Euro area are still unresolved. All sentiment indices remain under pressure regardless of the recent changes in the current fiscal and monetary policies. However, some research suggests that the EU appears to have entered a period of expansion following two recessions in close succession. The Centre for Economic Policy Research, which has responsibility for dating European business cycles, recently found that the Euro area had embarked on an upward phase of the business cycle in the first quarter of 2016. This concludes the recession that began in the second half of 2011. Growth is still unusually tepid, however, registering 1.5% in 2015, with the European Commission forecasting a fractional improvement to 1.6% in 2016. The UK economy remains in a solid recovery. The Bank of England stated in the first quarter that it will flood banks to prevent a run on the banks if voters are in favour of an exit from the EU, regardless of the risk of a weaker pound.

Japan

The Japanese economy is experiencing similar issues as the EU – achieving very little growth with stubbornly low inflation. The economy contracted by 0.3% in the last quarter of 2015, with a similar growth rate recorded for the first quarter of 2016. Inflation in January was 0%, with core measures slightly positive but still well below the 2% inflation target. However, in February, consumer prices increased to 0.3% year-on-year. The Bank of Japan is expected to review current stimulus measures on a continuous basis to turn the economy around. Like the Euro area, however, Japan is contributing essentially nothing to world growth according to the SARB, despite its substantial share in world output (around 4% of the total in purchasing power parity terms; the Euro area is close to 12%).

That said, strong economic recoveries in developed countries like the US and UK should support further medium-term earnings growth. However, poor economic growth in developing economies is not supportive of any positive outlook on earnings at this stage.

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Financial market review

Domestic assets

Domestic equities experienced a decent quarter thanks to a strong recovery in asset prices during March. The FTSE/JSE All Share Index (ALSI) generated a 3.87% return for the quarter and 6.44% for the month.

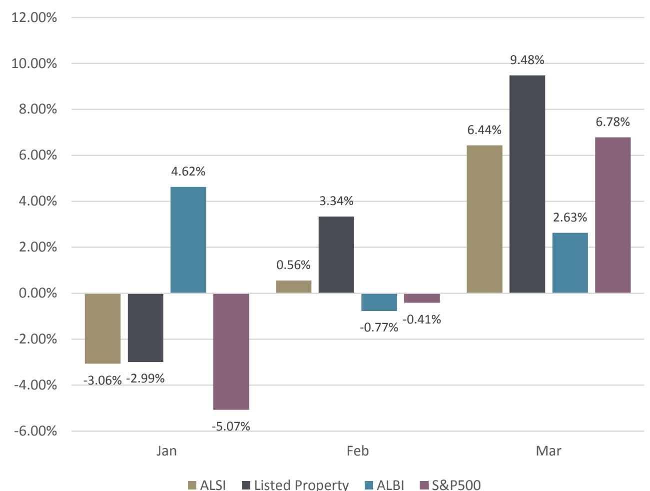
In the preceding quarter the industrial sector was the only one that recorded a positive return, delivering 6.10%. This quarter it was the only mainstream sector delivering a negative return, with a marginal 40 basis point loss. Resources provided some relief for investors, with a very strong recovery of 18.13% for the first quarter of the year. Financials gained 6.22% for the quarter, with bank results positively surprising investors. Listed property was reasonably flat for the quarter leading up to March. However, with a strong return of 9.48% for March, the sector managed to close the quarter with a 10.10% return.

If one takes a long-term view, the ALSI generated an annualised return of 13.57% over the last five years. Industrials, which gained 22.77% over the same period, have been the main driver of returns. Unfortunately, the resources sector was a significant detractor of returns over the past five years, recording a 9.61% annualised loss. Financials generated a 19.75% return over the same period. This is largely in line with the returns from the listed property sector, which came to 19.81% for the last five years.

We generally expect emerging markets to continue to struggle over the short term as commodity prices remain low. As recoveries in larger economies start to take place, we expect the Purchasing Managers' Indices (PMI) in emerging markets to signal improved growth, and perhaps the potential for higher spot prices on the back of increased demand. However, it's worth noting that more than 50% of the earnings of JSE-listed companies are generated abroad, and often in developed markets.

Although the macro-economic outlook for emerging markets look grim at the moment, careful stock picking may yield very different results to what local macro-economic variables may suggest.

The SA All Bond Index (ALBI) generated very strong returns over the quarter as bonds recovered from the poor investment sentiment witnessed in December 2015. The first three months of the year yielded 6.55% for the ALBI.



Sources: I-Net, JP. Morgan

Financial market review

Market indicators - as at 31 December 2015

Index	Quarter-end value	1M	3M	6M	1Y	3Y	5Y
ALSI	52 250.28	6.44%	3.87%	5.62%	3.17%	12.78%	13.57%
Industrials	78 444.21	5.03%	-0.40%	6.13%	8.75%	19.40%	22.77%
Resources	16 193.72	5.08%	18.13%	-4.57%	-25.45%	-11.89%	-9.61%
Financials	42 975.25	11.51%	6.22%	2.71%	-0.70%	16.47%	19.75%
Listed property	657.10	9.48%	10.10%	4.97%	4.57%	14.35%	19.87%
ALBI	492.34	2.63%	6.55%	-0.30%	-0.61%	3.97%	7.79%
VIX (S&P)	13.95	-32.12%	-23.39%	-43.06%	-8.76%	3.18%	-4.69%
S&P 500	2 059.74	6.78%	1.35%	8.49%	1.78%	11.82%	11.58%
Euro Stoxx	3 004.94	2.08%	-8.36%	-2.55%	-16.72%	7.48%	3.78%
Nikkei	16 758.67	4.57%	-11.95%	-3.62%	-12.75%	10.57%	11.43%
Hang Seng	20 776.70	8.71%	-5.19%	-0.33%	-16.56%	-2.33%	-2.46%
Dax	914.72	4.83%	-6.58%	3.27%	-14.40%	9.55%	7.99%
MSCI world	1 648.12	6.52%	-0.88%	4.18%	-5.32%	4.96%	4.69%
MSCI world ex US	1 647.69	6.33%	-2.68%	0.78%	-10.80%	-0.93%	-1.16%
FTSE 100	6 174.90	1.28%	-1.08%	1.87%	-8.83%	-1.23%	0.90%

Sources: I-Net, JP. Morgan
*Performance reported in base currency and indicate total return. Returns of periods exceeding one year have been annualised.

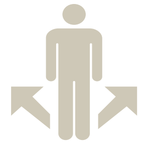
Global assets

On the global front, the S&P 500 generated an astounding 6.78% for March. This translates into capital inflation of $1.254 trillion dollars for this index for the month. The five-year historic annualised return for the S&P500 is now at 11.58% per annum in dollar terms. This, combined with the weakness in the rand over the period, has resulted in phenomenal returns for investors who implemented our advice to diversify offshore.

Another interesting observation on the return numbers of offshore indexes is that the Nikkei 225, Hang Seng, Dax and MSCI indexes were all negative for the three-month period, despite all of the same indices generating at least 4.5% for March. This is a testament to the increased volatility in offshore markets over shorter periods.

In terms of US sovereign debt, yields have started to increase more rapidly despite a more dovish stance taken by the US Federal Reserve. The 1-year government bond yield is now close to 2%. As noted in our tactical preferences note on valuations, we believe that US sovereign yields will continue to move upwards.

Tactical asset allocation preferences



Domestic equities

In our view, domestic equities were slightly overvalued at the start of this year and still markets continued to rally. Yet, the first quarter of the year resulted in a 3.87% return from the FTSE/JSE All Share Index (ALSI). An improvement in sentiment, which was at very low levels at the start of the year but later improved, driving the prices most asset classes - shares, bonds, property and some offshore assets higher over this period.

According to our assessment, domestic equities remain about 30% overvalued relative to their historic yield. There are certainly still some expensive pockets in the market, and investors should expect continued volatility at current levels (See our graph on the house tactical asset allocation preference at the bottom of this article). That being said, skilled stock pickers should be able to find value in selected shares. We remain of the view that nimble investors will benefit from more frequent opportunities created by increased volatility.

We are increasingly cognisant of the fact that there are some value traps on the local exchange – some counters are trading at very low price-to-earnings multiples, but the earnings are in a cyclical decline. We feel that risks abound for the inexperienced investor, and that a fair assessment of macro-economic factors is becoming increasingly important.

In addition, as local economic strength is waning, we look at corporate balance sheets and debt structures that will be able to weather the storms. We expect smaller businesses as well as businesses with low cash balances, weak cash flows and high levels of debt to struggle in prevailing economic conditions.

In light of the above, our positioning with regards to domestic equity remains as follows:

- underweight in interest rate-sensitive stocks and asset classes
- underweight in companies whose earnings rely heavily on domestic drivers
- underweight in companies who rely on leverage to grow margins
- overweight in multi-national conglomerates with actively managed exposure to both developed and emerging markets
- overweight in companies with strong balance sheets and healthy cash flows
- overweight in firms that are expanding operating margins and gaining market share

Domestic listed property

With regards to domestic listed property, our assessment of fair value shows that domestic property equity is now roughly 20% overvalued relative to its historic yield. In addition, we remain of the view that the interest rate cycle will impact domestic economic strength, affordability and sentiment. This will present headwinds for capital growth in the property sector. We therefore expect property yields to normalise on the back of capital value pressure.

There are, however, always some exceptions. Selected property shares are experiencing growing yields, which may present some opportunities. Although broad-based property exposure is ill-advised at this stage, we do believe there are some shares that can make a contribution to a diversified portfolio.

Where we hold listed property, we prefer to hold counters with the following characteristics:

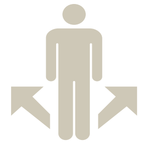
- low price-to-book values
- low levels of debt/gearing and strong credit ratings
- globally diversified portfolios, or counters that generate earnings abroad
- utilisation of structures that offer superior liquidity and diversification properties, like REITS
- superior distribution growth track records

Domestic bonds

Despite a surge in yields on the All Bond Index, the index aggregate yield still implies that this asset class remains generally overvalued. The implied premium is roughly 24%. With money market assets starting to offer some value, demand for bonds may dissipate in light of the

PSG Wealth

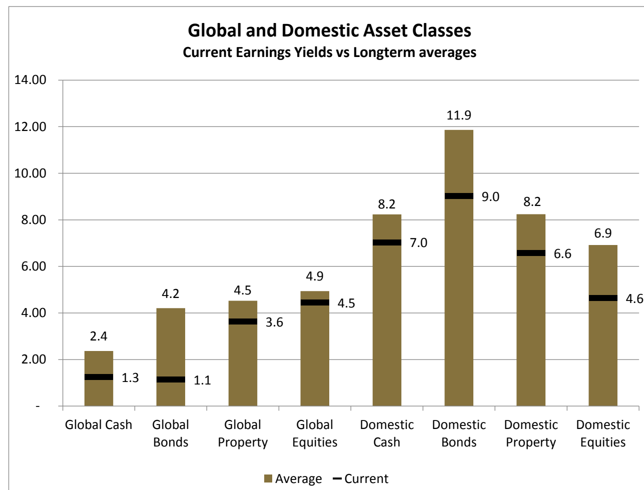
Tactical asset allocation preferences



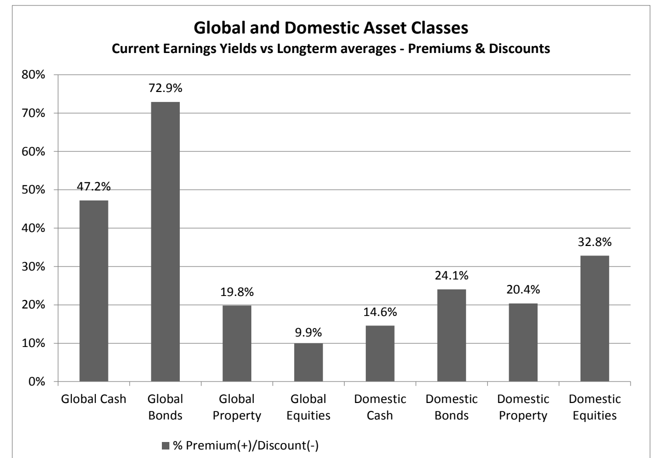
increased risk of holding them. The relative risk-adjusted returns of bonds are also being compromised by higher interest rates on the horizon.
Until recently, the gross real yield on most short-dated money market assets was near zero, and on an after-cost, after-tax basis there was very little to be excited about. However, as rate hikes ensue at an increased pace, we expect this to change quite drastically over the coming months.

During our previous quarterly review we stated that we expected interest rates to increase by 0.75% over the quarter. This is exactly what materialised. For the coming quarter we expect a 25bps hike in May and another 25bps hike in July. This is slightly less than what the South African forward rate curve is pricing in. The latter is pricing in a total increase of 80bps over this period.

Cash is certainly starting to offer value, with a three-month fixed deposit currently expected to yield close to 8% in nine months' time. We expect cash to play an increasingly important role in our portfolios over the coming months.



Source: PSG Wealth investment division



Source: PSG Wealth investment division

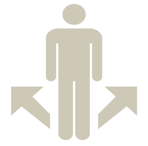
Global equity

Global equity valuations give a mixed picture. The forward price-earnings (P/E) ratios of developed economies seem to indicate that developed market equities may be fairly valued to slightly overvalued. The forward P/E ratios for developing economies appear undervalued. Strong economic recoveries in developed countries like the US and UK should support further medium-term earnings growth. However, at this stage, poor economic growth in developing economies is not supportive of any positive outlook on earnings.

The one forewarning to this assessment is that weaker emerging market currencies have made developing market assets more appealing to foreign investors, which may underpin some demand. Therefore, currency movements are likely to be one of the most significant factors to influence the success of these markets over the short term.

Global equities, although trading at a slight premium, remain the most attractive asset class in our minds. The underlying valuations remain sound and there are many quality firms to choose from. The biggest short-term risk for South African investors is the rand. That being said, there are many effective ways in which professional money managers can manage this risk effectively. We remain of the view that offshore equities remain attractive on a relative basis. Therefore we are cautiously optimistic about defensive developed market equity returns and remain overweight in this asset class.

Tactical asset allocation preferences



Global listed property

From a valuation perspective, global listed property is still a more risk-efficient investment than global bonds. Global cash yields, although increasing, remain unattractive. Still, investors should be very cautious in this segment of the market. Extreme property price fluctuations in structures with high leverage or limited liquidity can hold severe capital consequences for investors.

Global fixed interest and cash

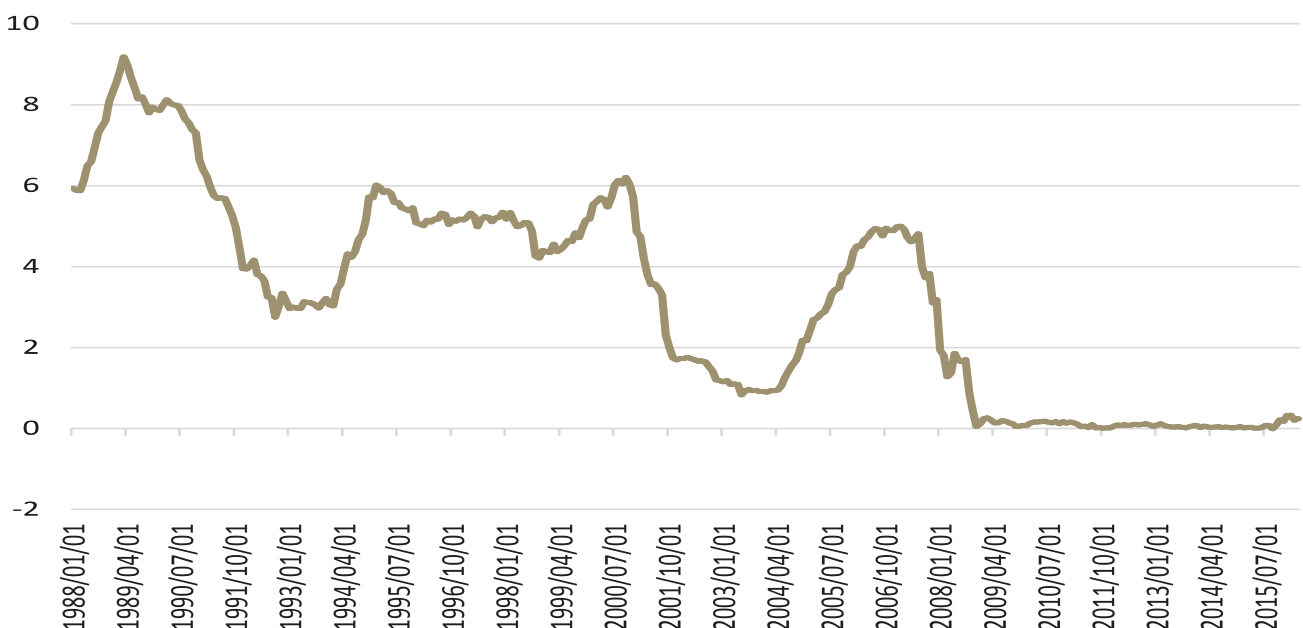
We are underweight in offshore fixed interest, as we believe that most of these asset classes do not sufficiently compensate investors for the inherent risks involved. Despite delays, we expect the rates and bond yields of the US Federal Reserve (Fed) to normalise during the course of the year.

Valuations on global bonds remain severely stretched on the back of unchartered monetary policy stimulus and subsequent capital flows to credit instruments. In the US, nominal and real 10-year treasury yields have been falling for the past 30 years, leaving both real and nominal yields historically low. Federal Open Market Committee research supports the view that current yields should increase by roughly 3% to normalise. Although recent statements by the Fed has implied a more dovish stance, rate normalisation will have to materialise at some point in the not-too-distant future.

Global cash remains unattractive apart from its liquidity and nominal capital protection properties. For investors seeking offshore diversification, equities offer the best value over an investment horizon suitable for an offshore investment.

Cash is certainly starting to offer value, with a three-month fixed deposit currently expected to yield close to 8% in nine months' time. We expect cash to play an increasingly important role in our portfolios over the coming months. Research supports the view that current yields should increase by roughly 3% to normalise. Although recent statements by the Fed has implied a more dovish stance, rate normalisation will have to materialise at some point in the not-too-distant future.

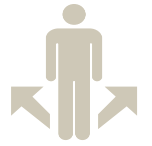
Yields of US Treasury Bill 10-Year



* Monthly values from 31 January 1988 to 30 April 2016
Source: I-Net Bridge

PSG Wealth

Tactical asset allocation preferences



EMERGING
South Africa

DEVELOPED
Global

Overweight: Tactical recommendation to hold more of the asset class than specified in the strategic asset allocation

Neutral: Tactical recommendation to hold the asset class in line with its weight in the strategic asset allocation

Underweight: Tactical recommendation to hold less of the asset class than specified in the strategic asset allocation

PSG Wealth

Domestic unit trust positioning

The South African rand – Where to from here?

A consistent subject appearing in local news is the expectation that the rand will weaken further. The underlying reasons for this pessimism includes sovereign risk, a weak economic outlook and fears of a credit downgrade.

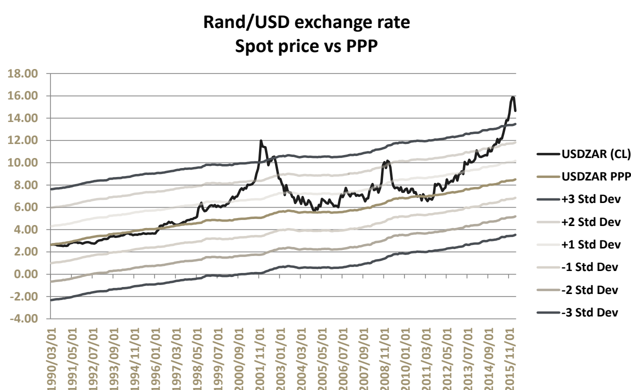
Quite often investors react to this news by shifting most of their investments offshore. The return on their offshore exposure is, after all, the only decent performance they have experienced since the middle of 2015.

Both the MSCI World Index and the J.P. Global Bond Index delivered negative returns in US dollar terms for the year ending 2015. However, due to a 35% weakening of the rand against the dollar, the returns of these two indices came in at 31.3% and 32.4% respectively when measured in rand.

This is also true for the one-year period ending 31 March 2016. The MSCI World Index and the J.P. Global Bond Index delivered returns of 14.3% and 25.8% in rand terms due to a 20.75% weakening of the rand against the dollar.

Valuing a currency

It is very difficult to determine whether a currency is overvalued or undervalued. However, the purchasing power parity (PPP) of a currency in relation to another currency, gives us an idea of what the fair value of the currency should be.



The previous graph indicates that the rand traded at R15.46 to the dollar at the end of December 2015 – more than four standard deviations above its fair value, reflected by the PPP of R8.41 to one dollar. It further shows that the rand strengthened by 5.2% in the first quarter of 2016. It traded at R14.65 to the dollar on 31 March 2016, compared to a PPP of R8.51 to one dollar. This is still close to four standard deviations above its fair value.

Factors influencing the value of the rand

The reason for the huge gap between the spot price and the PPP of the rand/dollar exchange rate is due to, amongst other factors, sovereign risk, the weak economic outlook and credit downgrade fears.

However, the recent Constitutional Court verdict on constitutional contraventions by both the president and National Assembly relating to the Public Protector's Nkandla report clearly shows that South Africa's judiciary system is intact. It also shows that South Africa will uphold the 'rule of law'. Pressure on the president to step down is mounting from both opposition parties and prominent members of the ANC, labour unions and civil societies. This may prevent further irresponsible political decisions by the ruling party – which adversely affect the rand.

We cannot argue against the poor economic conditions present in South Africa. Economic growth is currently very weak. The outlook is poor due to the drought, rising inflation and rising interest rates. However, we must not overlook some positive internal indicators. (See the box on page 19 for more detail). These include, amongst others, the narrowing of South Africa's trade deficit by R1.07 billion in February and the fact that for the first time in history, the South-African Revenue Service (SARS) collected more than a trillion rand in revenue.

PSG Wealth

Domestic unit trust positioning

Positive internal indicators

- South Africa's trade deficit decreased to R1.07 billion in February, falling significantly from the revised January deficit of R17.96 billion due to an increase in exports of 27% (R19.29 billion) to R90.68 billion. Imports rose by 2.7% (R2.4 billion) to R91.75 billion month-on-month (MoM). Exports increased by 16.5% year-on-year (YoY) and imports by 7.5%. Most importantly, these improvements were broad-based, with a MoM rise of 109% in vehicle and transport equipment exports, a 52% increase in precious metals and stones exports, a 28% boost in machinery and electronics exports and a 35% gain in vegetable products.
- SARS collected R1.0699 trillion in taxes for the 2015/16 financial year. This is the first time in our country's history that the revenue service has collected more than R1 trillion. This will definitely reduce pressure on government loans to fund government expenditure.
- Ford Motor Company has recently announced that it will invest R2.5 billion ($169 million) in its South African operations to start production of the Everest sport-utility vehicle and create about 1 200 jobs. BMW will also expand its South African plant in Rosslyn by purchasing further spaces adjacent to the factory to be reserved for a new facility for painting. Volkswagen South Africa committed to investing more than R4.5 billion by 2017 to increase the production capacity of its Uitenhage plant by 50%.
- Rising inflation and rising interest rates will have a less negative impact on South African consumers, because they have made use of the previous low interest rate cycle to pay off debts. Household debt to gross income decreased from 86.4% in 2008 to 78% in 2015. Similarly, household debt to GDP reduced from 44% in 2008 to 36.9% in 2015.

Despite these positive indicators, the possibility that ratings agencies may downgrade South Africa to sub-investment grade later this year is still high. However, markets generally discount these negative events well in advance.

Data of foreigners buying domestic equities and bonds are still positive. Foreigners have sold a total of R62.12 billion in South African equities for seven months in a row, compared to only R1.53 billion in South African bonds. In the first quarter of 2016, R21.97 billion in South African equities were sold, while R15.75 billion in South African bonds were purchased. From these figures it becomes clear that our poor economic outlook negatively affects equities. However, due to our higher interest rates and bond yields, our bonds are very attractive to the offshore market.

The factors mentioned in the previous block are internal factors that have a positive effect on the rand. The following are external factors which could also affect the rand:

- The weaker outlook for the world economy and the dovish comments regarding the American Federal Reserve's approach to rate hikes have already led to a weaker US dollar and stronger emerging market currencies, including the rand.
- A weaker dollar should be supportive of stronger commodity prices, and will benefit South Africa if broad-based improvements in exports continue.
- Current estimations indicate that foreigners have pumped $36.8 billion into emerging market stocks and bonds in March – the highest monthly inflow in nearly two years.
- There is a high possibility that voters in the UK will vote in favour of an exit from the EU. This should lead to a weaker pound and euro, and a stronger rand.

Data explained above makes it clear that there is a high degree of uncertainty about the immediate future of the rand. The weak rand may have already discounted most of the bad news, but there are various other factors that could still lead to a stronger rand.

Our view

Data explained above supports the PSG Wealth investment division's view that it's very important to have offshore exposure in investment portfolios in order to participate in diversification benefits. The benefit of diversification relates to quality offshore assets that are not available in local markets, at favourable prices.

Offshore exposure also acts as a risk measure that could

Domestic unit trust positioning

protect a country against an economic crisis. When foreign investors start to withdraw from a specific country, they will usually sell that country's assets down. However, a weakening currency should reduce the overall negative effect of a withdrawal. This is exactly what happened in 2015.

Investors are also indirectly exposed to offshore assets when investing in domestic shares with rand hedge properties. These companies earn a large proportion of their income from foreign countries, and in various foreign currencies. Some researchers have estimated that the largest ten shares on the FTSE/JSE All Share Top 40 Index have a rand hedge exposure of about 78%.

There is no single or simple answer to how much offshore exposure one should have in your investment portfolio. Investors need to identify their current offshore exposure, and adjust this exposure to a more appropriate level based on the following:

- the objective of the investment (growth, protecting purchasing power or providing an income) as well as the investor's investment horizon
- the investor's risk profile and ability to withstand short-term volatility

Positioning of the domestic fund of funds (FoFs)

Name	3 Months to 2016/03/31
PSG Wealth Creator FoF D	4.29
PSG Wealth Moderate FoF D	2.97
PSG Wealth Preserver FoF D	1.76
PSG Wealth Income FoF D	2.47
PSG Wealth Enhanced Interest D	1.87

Source: PSG Wealth investment division

PSG WEALTH ENHANCED INTEREST FUND

This low-risk fund's objective is to maximise the current level of income, while providing maximum stability of capital invested over an investment horizon of less than one year. The fund has no offshore exposure, because any offshore exposure would put the stability of the capital invested at risk.

The PSG Wealth Enhanced Interest Fund outperforms the South Africa IB Money Market Sector average over all measurement periods of four years and less. It also delivered very competitive returns compared to the best performing money market fund.

The fund will continue to benefit from higher inflation and rising interest rates and will continue to deliver favourable short-term returns.

PSG WEALTH INCOME FOF

This fund is a low-risk fund with the objective to generate income and long-term capital appreciation over an investment horizon of two years. The fund has an offshore exposure of 12.3%, consisting of various asset classes. This adds some diversification to the portfolio.

The PSG Wealth Income FoF outperforms both the Stefi 12 Month NCD and the South African MA Income Sector average over all measurement periods of five years and less.

Higher inflation and rising interest rates may be a drag on performance over the short term, but we are confident that the underlying portfolio managers will lock in the benefits of higher interest rates, reaping attractive fruits after the interest rate cycle has peaked.

PSG WEALTH INCOME FOF

This low- to medium-risk fund's objective is to create medium- to long-term capital growth within an acceptable level of volatility, over an investment horizon of three years. The fund has a gross offshore exposure of 25.5%. Three of the underlying managers have a currency hedge in place to reduce the net exposure of their portfolios to within the maximum allowable 25%.

The PSG Wealth Preserver FoF outperforms the South African MA Low Equity Sector average over all investment periods of three months and longer. It also outperforms its performance target of CPI +3% over all investment periods of two years and longer. Higher inflation is going to increase the performance hurdle of this fund in the

Domestic unit trust positioning

coming months, while rising interest rates will continue to be a drag on performance.

The PSG Wealth Preserver FoF is a well-diversified portfolio that will protect the capital of clients during negative markets.

PSG WEALTH MODERATE FOF

This fund is a moderate-risk fund with the objective to create medium- to long-term capital growth within an acceptable level of volatility over an investment horizon of five years. The fund has a gross offshore exposure of 27.5%. Three of the underlying managers have a currency hedge in place to reduce the net exposure of their portfolios to within the maximum 25% allowed. Investors with a need for more offshore exposure may utilise some of their discretionary investments to invest in the PSG Wealth Global Moderate FoF (USD) or the PSG Wealth Global Moderate Feeder Fund (FF).

The performance of the PSG Wealth Moderate FoF has also improved due to the 5.4% return of the PSG Balanced Fund. This compares favourably to the 1.6% return of the South African MA High Equity Sector average over the first quarter of 2016.

The PSG Wealth Moderate FoF is a well-diversified portfolio and we are confident that the fund will continue to deliver above-average long-term returns over all market cycles.

PSG WEALTH CREATOR FOF

This high-risk fund's objective is to create long-term capital growth over an investment horizon of five to seven years. The fund has a gross offshore exposure of 15.4%. This fund also has a large rand hedge exposure, but investors with a need for more direct offshore exposure may utilise some of their discretionary investments to invest in the PSG Wealth Global Creator FoF (USD) or the PSG Wealth Global Creator FF.

The performance of the PSG Wealth Creator FoF has improved noticeably over the first quarter of 2016. The PSG Equity Fund was the star performer for the quarter, achieving a return of 9.1% compared to the 4.5% of the South African EQ General Sector average. We have noticed that the performance of the Prudential Equity Fund, on the other hand, is starting to lag.

The outlook for equities has deteriorated due to higher valuations and weaker earnings growth. However, we remain confident that the relative performance of the underlying managers in the fund will improve in the near future. The fund will continue to deliver above-average long-term returns over all market cycles.

PSG Wealth

Offshore mutual fund positioning

Selecting from a broader global manager universe – 'offshore for offshore'

This quarter's global fund update provides a summary of the process followed to identify new managers, while also providing insight into our global investment process and the funds we invest in.

Recent adjustments to the PSG Wealth Global Creator Fund of Fund has made PSG Wealth the only current retail client of T. Rowe Price on the African continent. This American investment firm situated in Maryland is the 26th-largest asset manager in the world and currently manages $725.5 billion in assets.

Combined with the other two additions to the PSG Wealth Global Creator FoF, the Fundsmith Equity Fund and the Vulcan Value Equity fund, our FoF is now part of three uniquely positioned global funds. (See description of these funds on page 24.)

BACKGROUND

A key advantage of the PSG Wealth global FoFs is the broader universe of investment managers we have access to. This gives our clients exposure to highly experienced and skilled global managers who cannot easily be accessed directly. This is due to regulatory restrictions and investment constraints, such as minimum investment sizes (some funds have minimums of $50 million and more) and varying sales regions (e.g. funds that do not have representatives based in South Africa). By starting our screening process with the whole universe of open-ended funds (of which there are over 230 000), we are able to consider funds that are not available in South Africa – providing greater access to clients.

The PSG Wealth global FoFs are domiciled in Guernsey, which allows us to invest in most global funds (within the limits of the individual FoFs' mandates). However, South African legislation provides specific guidelines that global funds must comply with in order to be approved for distribution in South Africa (refer to Section 65 of the Collective Investment Schemes Control Act 2002). By conducting a thorough due diligence based on the FSB guidelines, we are able to satisfy these legal requirements.

We believe a fund that passes our due diligence process would more than likely be approved by the FSB if they applied for section 65 approval. Our own global FoFs are FSB approved and available to investors in South Africa. This provides an excellent access point for investors to gain exposure to highly experienced and skilled global managers.

We believe that when constructing a global portfolio, a fund selector needs to be able to consider all relevant global managers and not just those which are operationally easy to access (e.g. locally managed global funds). It is important to keep in mind that in the global context, South Africa is a relatively small market – so very few global managers have gone through the process of registering their funds locally. By expanding our universe to incorporate these managers we believe we can offer global FoFs that consist of true global managers – 'offshore for offshore'.

Please note that the Fundsmith Equity Fund and T. Rowe Price Global Focused Growth Equity Fund are non-FSB approved funds and are not available for direct investment. We encourage you to utilise our fund of funds structure, as PSG Wealth has a discretionary mandate to manage these global funds. We constantly monitor all underlying funds and ensure portfolio compliance with all required legislation. Given our discretionary mandate it is important to note that we can at any time disinvest from these funds.

Offshore mutual fund positioning

Why 'offshore for offshore'

The benefits of this greater investment universe are significant. Foreign-based managers:

- have a much larger global footprint (regional offices, sector-specific teams, etc.)
- can offer funds at significantly lower fees due to economies of scale
- generally have larger, more experienced investment teams
- generally have very well developed and tested investment philosophies and processes

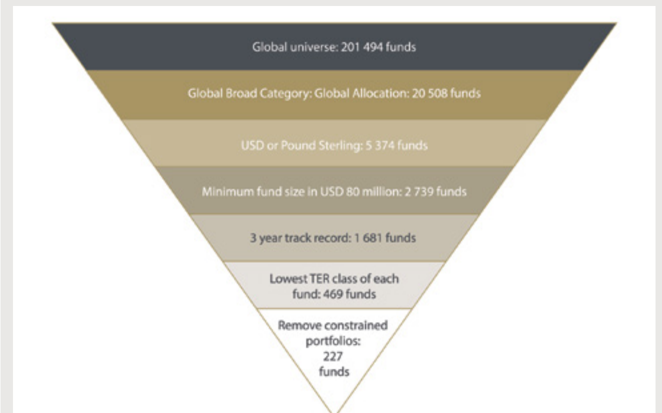
Some of the managers we have identified have exceptionally long track records, through various market cycles. Some can even claim such unique milestones as developing the concept of growth as an investment style or launching the first mutual fund in the world. Even though a number of South African based managers have successfully delivered alpha in global mandates, we believe the potential benefits of utilising pure offshore managers is a unique advantage that the PSG Wealth global FoFs offer our clients.

PSG Wealth Global Creator – Investment process to identify new funds

In the Summer 2015 edition of the Research and Strategy Report, we explained that the first step in the manager selection process is defining the managers universe. Our local unit trust universes are based on the classifications of the Association for Savings and Investment South Africa (ASISA), which simplify the local process. For our global funds, defining a universe is considerably more challenging – an accurate classification system that correctly classifies global funds within clearly defined categories, 100% of the time, does not exist.

For this reason, the PSG Wealth investment division has developed an in-house fund screening system (see explanation in next block).

In-house screening process for the PSG Wealth Global Creator FoF



Source: PSG Wealth investment division

Removing constrained portfolios refers to a qualitative analysis of a fund's mandate to ensure they are not inhibited by any of the following factors:

- investment constraints (regions, sectors, etc.)
- operational constraints (FoFs, sales regions, access to information, etc.)
- FSB approval constraints (non-UCITS, hedge funds, etc.)

Advantages of the above screening process and the subsequent custom universe are:

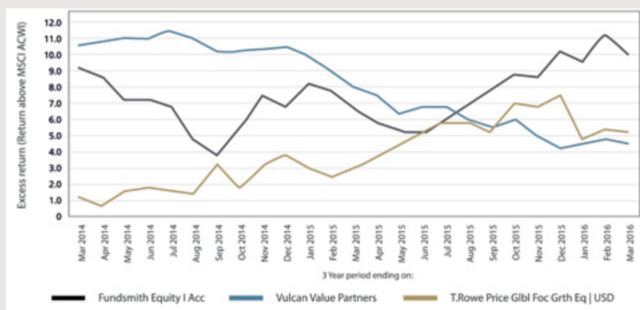
- a more realistic ongoing management and review process
- a more transparent process
- a process that improves accountability and drives quality
- a more appropriate peer group ranking (ranked against funds that are investable according to our mandate)

Offshore mutual fund positioning

Quantitative analysis observations of three new funds

Once appropriate funds are identified, an extensive quantitative analysis is conducted to further identify managers that have historically shown investment skills (The quantitative analysis is not used as an indicator of future performance, rather it is used as a confirmation mechanisms to identify if the manager's process has stayed consistent over time and has previously been able to provide an excess return through identifiable skill). Some observations from our quantitative analysis of these funds are illustrated in the graphs of page 27 and 28.

Consistent outperformance of MSCI ACWI Total Return Index



Source: Morningstar Direct

The rolling return chart illustrates the managers' three-year excess returns (returns above the market index) rolling by one month (i.e. each period moves one month forward in time). All three managers have shown a consistent ability to outperform the index over relevant periods. Various time periods are used in the analysis to identify a manager's skill over different market cycles. When UCITS*-compliant versions do not have long performance histories, we use various methods to identify through-the-cycle performance, such as investigating similar mandates the manager runs in the US (mutual funds) or, in some cases, separately managed accounts that are managed with an identical mandate for large international institutional clients.

These are just a few of the quantitative metrics used in our analysis of investment skill. As noted in the Summer 2015 edition of this report, we do not believe that past performance is a good indicator of future performance and past performance on its own is not a reasonable basis for an investment.

Key to our process is the detailed qualitative analysis (including the operational and investment due diligence) of each manager. As part of the due diligence phase of our process, the PSG Wealth Fund Committee travelled to Boston, USA in October 2015 and conducted interviews with over 14 managers, including BlackRock, Franklin Templeton, Fundsmith, Goldman Sachs, T. Rowe Price, Wells Fargo and Vulcan Partners. The committee also attended the annual US FundForum to gain insights on the US fund industry. Meeting with the manager is key to our process, and gives the research team and the PSG Wealth Fund Committee the opportunity to get a detailed understanding of their investment process and key characteristics of their portfolios. It also allows time for insight into the manager's investment approach.

Summary of the new managers' investment philosophies and processes

FUNDSMITH EQUITY

Fundsmith is a UK-based investment manager established in 2010 by Terry Smith, one of London's best-known financial executives. Smith previously oversaw one of the world's biggest brokerages, which specialises in handling trades between banks. Fundsmith is owned and controlled by key staff members, who have worked closely together over many years. Their headquarters are in London, with an additional office in Connecticut, USA. As of 31 October 2015 they managed £4.5 billion in global equities.

The manager's focus is on high-quality businesses that will compound in value over time. The first stage of the process is to identify resilient, quality companies. To be included in the manager's investable universe, a company needs to meet all of the below quality criteria:

*UCITS stands for Undertakings for Collective Investments in Transferable Securities. UCITS provides a single European regulatory framework for an investment vehicle, which means it is possible to market the vehicle across the EU without worrying about which country it is domiciled in.

Offshore mutual fund positioning

- high returns on operating capital employed in cash throughout the cycle (more than 3% above their cost of capital)
- consistent sustainable growth (operating margins greater than 10%) driven from the reinvestment of their cash flows at high rates of return back into their own business (conversion of majority net income into free cash flow)
- no significant leverage required to generate returns
- resilient to change, particularly to technological innovation
- operating in sectors with intangible advantages: brands, distribution, installed base, franchisers, etc.
- make money by a large number of repeatable, predictable events.

Additionally, their process sets specific factors that will exclude a company from the investable universe, such as companies that require significant leverage, are cyclical or companies with significant exposure to products that are reaching the end of their life cycle (obsolescence). Thus there are a number of businesses and sectors that they won't invest in, such as airlines, banks, real estate, biotech, fashion companies, insurance, materials, oil and mining, technology, and utilities and telecoms.

The fund also has a bias for large caps, only considering companies with a market cap greater than USD2 billion. The result is an investable universe (as at end of 2015) of about 65 stocks.

A critique of the above process is that many of these companies are trading at relatively high valuations. This leads us to the second stage of the process, which is focused on valuation. Valuation is conducted by estimating the free cash flow of every company after tax and interest (but before dividends and other distributions), and after adding back any discretionary capital expenditure which is not needed to maintain the business. The aim of the process is to invest only when free cash flow per share, as a percentage of a company's share price (the free cash flow yield), is high relative to both long-term interest rates and the free cash flow yields of other investment candidates, both within and outside the portfolio. Based on this valuation approach the manager believes there are still some opportunities available.

The third stage of their process speaks to the holding period, which is basically a buy-and-hold strategy. According to the manager their ideal holding period is 'forever'. This matches the fund turnover, which is very low (+-3.2% p.a.).

The result of the process is a fund with a highly concentrated portfolio of between 20 to 30 stocks. Stocks are focussed on high-quality, resilient companies selected through a distinctive disciplined approach that the manager wants to own 'forever'.

T. ROWE PRICE GLOBAL FOCUSED GROWTH EQUITY

T. Rowe Price is an American publicly owned investment firm, headquartered in Baltimore, Maryland. It was founded in 1937 by Thomas Rowe Price, Jr. The company's founder may be best known for developing the growth stock philosophy of investing – emphasising companies whose earnings and dividends could be expected to grow faster than inflation and the overall economy. The company currently manages $725.5 billion (it is the 26th-largest asset manager in the world), which spans all major public asset classes. It has 234 research analysts worldwide.

The Global Focused Growth Equity strategy is a 'best ideas' portfolio that leverages the manager's global structure to construct a concentrated portfolio of 70 to 80 stocks. This fund has $3.8 billion assets under management. The team consists of 12 sector portfolio managers, 90 research analysts, 40 associate research analysts, six quantitative analysts and six speciality analysts.

The manager's view is that markets underestimate the return potential of market share gains and innovation, and that identifying what is being missed by the rest of the market is key to delivering alpha. The philosophy of the portfolio is focused on identifying, through a fundamental bottom-up approach, companies with superior and sustainable growth prospects and improving fundamentals (e.g. attractive industry structure, sustainable competitive advantage, market share gains, favourable business cycle, shareholder-focused management team, etc.). A key focus of the process is identifying companies with improving return on capital.

Offshore mutual fund positioning

Macroeconomic and local market factors are integrated in stock selection decisions. Contrarian to most value managers, the team looks for value realisation within a 12- to 24-month period (e.g. when the fundamental thesis and return forecasts are reflected in the stock price).

The portfolio has a single decision maker, which provides clear accountability. The portfolio manager is supported by two dedicated team analysts, who assist with financial analysis and the application of the investment process. This also allows for travel and time zone management. They are in constant contact with the 12 sector portfolio managers to obtain their unique insights into the various global equity sectors and the securities within these sectors. (The sector portfolio managers are assisted by the various sector/regional-focused research analysts).

Each sector portfolio manager is responsible for their own sector-specific portfolios. The main portfolio manager leverages the feedback from the sector portfolio managers in the portfolios to identify the best ideas within the group and utilises these stocks in the construction phase of the Global Focused Growth Equity fund.

Active positions of about +-10% on a country basis (+- 20% US) and +-15% on a broad-sector level can be taken relative to the benchmark (MSCI All Country World Index). Valuation matters in the process, but it matters most at extremes (e.g. unsustainably cheap or unjustifiably expensive price points).

A standout aspect of T. Rowe price is their seasoned portfolio management teams, which average 22 years of investment experience and 17 years tenure with T. Rowe Price. The Management Committee averages 30 years with T. Rowe Price.

VULCAN VALUE EQUITY

Vulcan Value Partners ('Vulcan') is a value-driven, benchmark unconstrained, long-only US equity-focused asset management firm. Vulcan was founded in 2007, manages approximately $12.5 billion and is based in Birmingham, Alabama. C.T. Fitzpatrick established Vulcan Value Partners. Before that he spent 17 years as portfolio manager at South-Eastern Asset Management where he was jointly responsible for $40 billion in assets. The team has over 70 years' combined experience in investment markets and currently employs 32 staff members.

Vulcan focuses on identifying high-quality, publicly traded businesses that are priced at a discount to their intrinsic value. Vulcan's primary objective is to minimise the risk of permanent loss of capital by demanding a substantial margin of safety, through value identification in companies that have a sustainable competitive advantage. The secondary objective is to compound capital at real rates of return (i.e. above inflation) over a five-year time horizon.

Vulcan's core belief is that the quality of an investment is of paramount importance. To that end Vulcan limits its search for eligible investments strictly to 'good' or 'great' businesses. The manager's definition of a good business is the production of free cash flow, because it believes that businesses that are truly competitively entrenched will generate high levels of relatively predictable free cash flow. Those that are not competitively entrenched do not generate this free cash flow.

Vulcan is not interested in business enterprises with inferior economics that appear statistically cheap. This is one of the key differentiating factors of its investment approach, compared to those who follow a more traditional school of value investing.

Having identified the possible universe of high quality companies, Vulcan selects only those that are trading at a discount to its calculation of intrinsic value for inclusion in its portfolios. Requiring a margin of safety for portfolio investments ensures a greater probability of earning excess returns as price moves to fair value.

The final element of Vulcan's portfolio construction is the process of determining the number of portfolio companies to invest in. In an environment when discounts are smaller, Vulcan adds a further margin of safety by holding a larger number of less discounted ideas. Conversely, when discounts are wider, Vulcan will hold fewer ideas, each with a greater margin of safety. The result is a portfolio of between 20 and 50 companies with multiple margins of safety.

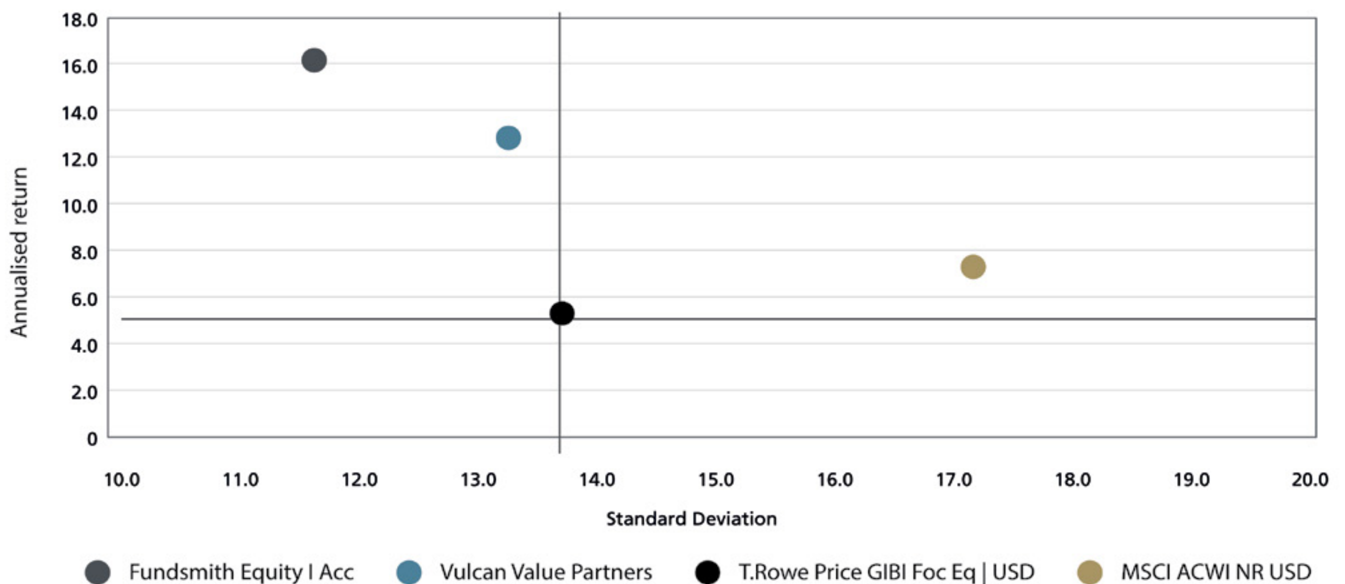
Offshore mutual fund positioning

Relative performance and risk measures

5 year performance					
Time period: 2011/04/01 to 2016/03/31 Currency US Dollar Source Data: Total Return					
	Annualised Return	Sharpe ratio	Information ratio	Beta	Max drawdown
Fundsmith Equity I Acc	16.17	1.38	1.56	0.75	-9.22
Vulcan Value Partners	12.86	0.96	1.33	0.89	-15.87
T.Rowe Price Glbl Foc Grth Eq I USD	7.34	0.42	0.33	1.18	-22.19
MSCI ACWI NR USD	5.22	0.38		1.00	-20.47

Source: Morningstar Direct

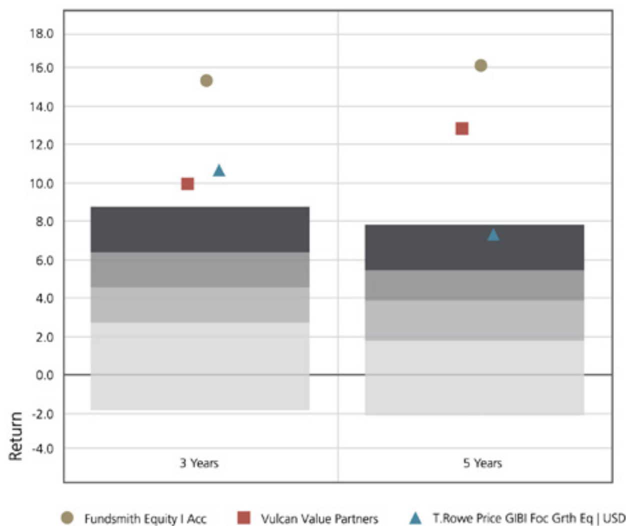
5 Year Risk-Reward



Source: Morningstar Direct

Offshore mutual fund positioning

Relative performance and risk measures



Source: Morningstar Direct

The information ratio (IR) quantifies risk-adjusted returns, separating the skilled managers (those who consistently outperform) from the lucky. It is defined as the ratio of the (annualised) average excess return over the benchmark, divided by the (annualised) standard deviation between the manager and the benchmark. A manager with an IR above 0 has illustrated skill over the period, with an IR above 0.5 indicates a top-quartile performer. As can be seen from the chart, all three funds we have identified have information ratios well above average for a five-year period ending 31 March 2016. As noted earlier, our analysis uses various periods to identify skills in different market situations.

The Sharpe ratio illustrates a manager's excess return per unit of risk. Thus a higher number indicates that the manager is able to generate relatively more excess return for each unit of additional total risk taken. All three managers have Sharpe ratios well above the market index and rank relatively highly against the peer group.

The beta of an investment indicates whether the investment is more or less volatile than the market. In general, a beta of less than 1 indicates that the investment is less volatile than the market, while a beta of more than 1 indicates that the investment is more volatile than the market. Maximum drawdown is an indicator of the risk of a portfolio based on a certain strategy. It measures the largest single drop from peak to bottom in the value of a portfolio (before a new peak is achieved). The three portfolios have very different strategies and this can be seen in the differences between their risk measures.

PSG Wealth portfolio construction

Each manager is analysed on an individual basis and rated according to various qualitative and quantitative criteria. However, it is important to note that on their own the above funds potentially pose significant risks, specifically due to their concentrated nature. This could result in performance that deviates significantly from the relevant market index (both positively and negatively).

All investment decisions are made in the context of the overall portfolio. As such, every potential manager is investigated based on the total FoF portfolio's potential alpha profile, risk exposures and fees. We use various portfolio simulations and stress tests to determine the potential impact a new fund could have on the risk exposures of the overall portfolio. For example, the risks posed by the concentrated nature of the three new managers in the Global Creator FoF is managed by exposure to less concentrated portfolios like the Sanlam World Equity Tracker and Schroder International QEP Global Core.

As illustrated throughout this article, having a larger global universe has many potential benefits. This is the key advantage of investing in the PSG Wealth global FoFs. However, investing in an expanded global universe also brings many potential risks. The PSG Wealth investment division investigates these risks through its due diligence process before new funds are cleared for entry and actively managed in our global portfolios.

Offshore mutual fund positioning

Global funds – performance and positioning

The PSG Wealth Global Creator FoF had a strong 12-month period ending March 2016, with each of the underlying managers contributing positively to alpha. Managers focused on large-cap quality companies, which delivered a very strong performance over this period.

The PSG Wealth Global Moderate FoF had a difficult 12 months, with performance hampered by exposure to emerging markets, deep value European equities and specific positions within the basic materials sector. The PSG Wealth investment division is currently in the process of finalising the due diligence of a number of promising managers, which we believe will add value to the portfolio in future.

1-year performance to 31 March 2016		
Fund name	%	Rank
PSG Wealth Global Creator FoF D (USD)	-1.2	22
BM: GIFS Global Large-Cap Blend Equity (USD)	-4.8	135
PSG Wealth Global Creator FF D (ZAR)	18.9	8
Peer Group: ASISA Global EQ General (ZAR)	14.0	40
PSG Wealth Global Moderate FoF D (USD)	-5.3	124
BM: GIFS USD Flexible Allocation (USD)	-6.2	226
PSG Wealth Global Moderate FF D (ZAR)	13.8	15
ASISA Global Multi Asset Flexible (ZAR)	15.0	21

Source: PSG Wealth investment division

Look-through positioning of the PSG Wealth Global Moderate FoF

Over a volatile first quarter of 2016 most of the underlying managers decreased their equity exposure, resulting in the FoFs' net equity exposure decreasing by 3.1%. Within equities, overweights in Financials and Industrials were decreased by 1% and 1.8% respectively, while there were slight increases in exposure to Consumer Defensive (+0.3%) and Communication Services (+0.2%). Offshore cash exposure increased slightly (+0.8%) and remains relatively high, indicating the defensive positioning of most of the managers. There were some opportunities in global property during the quarter, resulting in our underlying managers selectively increasing exposure by a net 0.5%. Most of the managers remain cautious on global bonds and net exposure in the FoF decreased by 0.2% over the quarter. With regards to regional allocation, the FoF currently has 92.3% invested in developed markets and 7.7% in emerging markets. Develop market exposure is mostly in the US (44.1%) and the EU (17.9%).

PSG Wealth Global Moderate		
Asset allocation	Current %	Previous quarter
Foreign Equities	**63.7**	**66.8**
Basic Materials	2.3	2.5
Communication services	2.8	2.6
Consumer Cyclical	7.0	7.1
Consumer Defensive	6.2	5.9
Healthcare	6.1	6.7
Industrials	6.5	8.3
Technology	7.9	8.0
Energy	2.8	2.8
Financial services	21.7	22.7
Utilities	0.5	0.5
Foreign property	**2.2**	**1.7**
Foreign bonds	**10.1**	**10.3**
Foreign other	**3.2**	**1.2**
Foreign cash	**20.8**	**20.0**
Domestic assets	**-**	**-**
Portfolio Total	**100%**	**100%**

Source: PSG Wealth investment division

PSG Wealth

Offshore mutual fund positioning

Look-through positioning of the PSG Wealth Global Creator FoF

PSG Wealth Global Moderate		
Asset allocation	Current %	Previous quarter
Foreign Equities	**95.8**	**94.8**
Basic Materials	2.5	3.1
Communication services	1.4	1.9
Consumer Cyclical	11.4	12.2
Consumer Defensive	13.7	13.6
Healthcare	16.7	17.0
Industrials	12.0	11.0
Technology	19.5	16.8
Energy	3.0	3.5
Financial services	15.1	14.7
Utilities	0.6	0.9
Foreign property	-	-
Foreign bonds	-	-
Foreign other	**0.1**	-
Foreign cash	**4.1**	**5.2**
Domestic assets	-	-
Portfolio Total	**100%**	**100%**

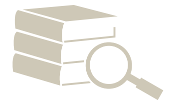
Source: PSG Wealth investment division

Over the last quarter our underlying managers reduced exposure to the Consumer Cyclicals (-0.8%), Basic Materials (-0.6%), Communication Services (-0.5%), Consumer Defensive (-0.6%) and Energy (-0.5%) sectors.

They significantly increased exposure to the Technology (+2.7%) and Industrials (+1.0%) sectors, with slight increases in Financial Services (0.4%) and Consumer Defensive assets (+0.1%).

Regionally, the FoF is invested mostly in developed markets (97%) with a US overweight (64%), and is currently underweight in emerging markets (3%).

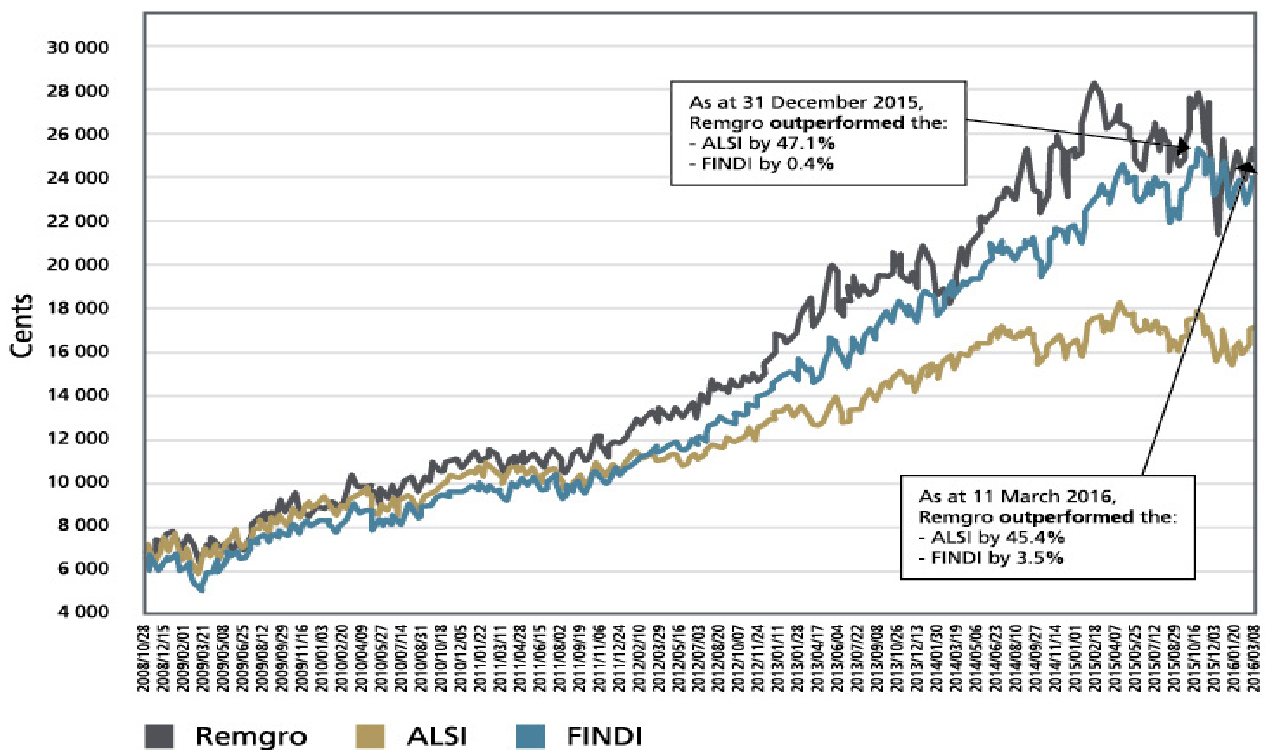
Equity research



Remgro: a diversified investment holding company

Remgro is a diversified investment holding company with investments in listed and unlisted companies focused on the financial and industrial sectors of South Africa. The group has consistently managed to adapt to changing environments throughout its 68-year history. Its entrepreneurial management teams and consistent investment philosophy – of being a patient investor in defensive industries with business models that are supported by strong cash generation – have translated into a long history of market-beating returns generated in a cost effective manner.

Remgro share price information

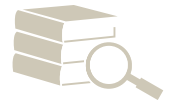


Source:Remgro Limited

Despite its conservative nature, the group has not shied away from pursuing meaningful green field operations. This is a form of direct investment where a parent company starts a new venture in a country by constructing new operational facilities from the ground up. In addition to building new facilities, most parent companies also create new long-term jobs in the foreign country by hiring new employees. Vodacom, Tracker and Dark Fiber Africa originated in this way. Remgro manages its investments on a decentralised basis. Its involvement is concentrated mainly on the provision of support, rather than on being involved in the day-to-day management of business units of the investees.

Local economic growth is expected to slow and remain weak in the short- to medium-term, impacted by increasing inflation and a rising interest rate cycle. This should translate into lower disposable income. This weak growth should filter through into more muted trading conditions for the majority of locally focused financial

Equity research



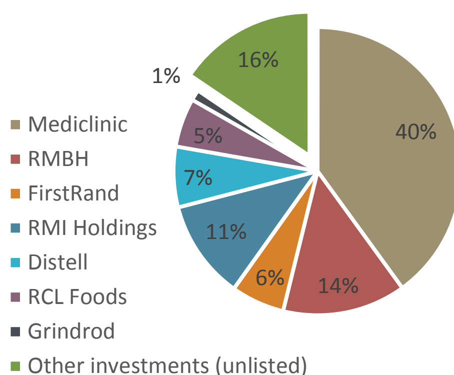
and industrial shares. The growth investments Remgro is exposed to are scarce commodities in the current economic environment. The majority of the group's investments display strong earnings momentum and have credible initiatives to maintain and improve this momentum.

In addition, we feel that management is actively pursuing initiatives to reduce the discount at which it has historically traded relative to its intrinsic value. These initiatives include actively supporting investees (as illustrated by the Al Noor acquisition and MEI right issue) and the removal of the cash drag on the balance sheet. Remgro has committed R20 billion to capital transactions over the last 12 months (14% of its intrinsic value) to support growth initiatives.

The group's portfolio is dominated by sector-leading companies. Compared to their competitors, we are of the opinion that the growth strategies of Remgro's investee's are articulated the best in their respective industries. Their growth strategies range from investments in technologies expected to disrupt traditional financial services to pursuing acquisition intended to expand their international reach, or improve their competitive positioning. Remgro has historically been supportive of the growth plans of its investees and has even facilitated these transactions.

Company contribution to intrinsic value at 7-Apr-2016

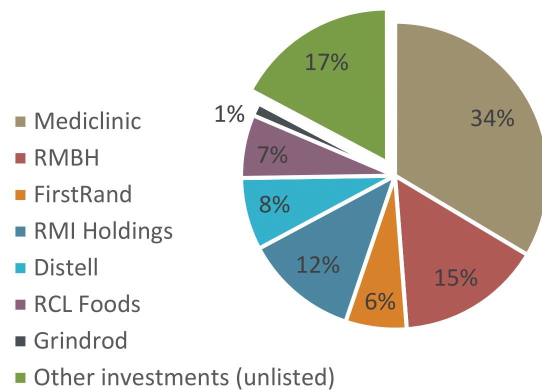
(excluding other investments, treasury, corporate costs and potential CGT)



Source: PSG Wealth investment division

Company contribution to intrinsic value at 31-Dec-2015

(excluding other investments, treasury, corporate costs and potential CGT)



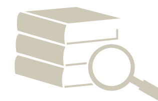
Source: PSG Wealth investment division

We feel Remgro's investee companies have appropriate strategies in place to sustain its resilient operational performances. We review their growth strategies to better understand the drivers of Remgro's performance going forward.

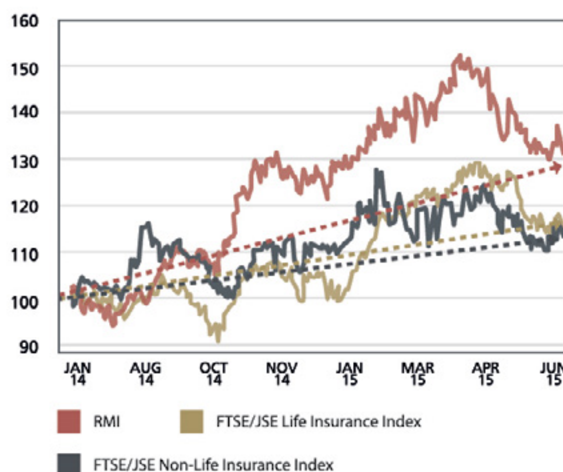
RMI

RMI currently contributes 11% to Remgro's intrinsic value. The group recently changed its name from Rand Merchant *Insurance* Holdings to Rand Merchant *Investment* Holdings to reflect the change in its focus. The group is comprised of an attractive portfolio of companies in the financial services sector, each with its own defined strategies for growth. The group has embraced corporate activity to enlarge and improve its portfolio of investments and has a successful history of investing and start-up operations. The group's share price performance, relative to its peers, is indicative of the success management has had with its strategy.

Equity research



RMI vs listed life competitors



Source: PSG Wealth investment division

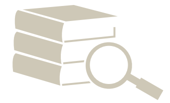
RMI's current investments include:

- **Discovery**: Discovery's defensive characteristics add appeal to the investment amid uncertain economic conditions, but its management has significant growth aspirations. Discovery's strategy is to leverage its niche Vitality IP by partnering with international insurers. Given the size of these partners' markets, the potential opportunity is significant. The first of these partner models, Ping An Health in China, commenced back in 2010 when Discovery identified an opportunity in the Chinese private healthcare market as the government pursed several healthcare reforms. The opportunity in China remains attractive given the size of the population, which is moving away from their social health insurance system. Discovery's partner model offers significant earnings potential with a small capital outlay. Discovery also intends to develop its own banking operations as a new area of growth for the business.
- **MMI**: In addition to pursing growth offshore, MMI has been actively involved in facilitating disruptive innovations through several fintech ventures.
- **Outsurance**: Outsurance has been successful in replicating its popular local model in Australasia under the Youi brand. Australia now contribute approximately half of the group's gross premiums. Youi presents the group with good growth potential over the medium term as the personal lines in the local operations mature. Youi was recently rolled out in New Zealand. Its local operations will focus on improving its commercial market share. The group is also refining a strategy to benefit from the potential disruptive impact that the broader use of telematics devices might have on the global vehicle insurance market.
- **AlphaCode**: In addition to the traditional insurance businesses, RMI recently established a new venture in investment management, as well as a next-generation investment arm operating under the brand AlphaCode. AlphaCode is essentially a venture capital fund, focused on partnering with entrepreneurs with disruptive business models in the financial services industry. RMI has a solid platform to support these investments with existing infrastructure, distribution capabilities, capital and a team of experienced industry leaders. The group has set aside R1 billion for these next-generation investments.
- **Investment management**: An affiliate model has been adopted for the investment management business, which is aimed at acquiring equity stakes in boutique and independent managers. The proposition for the model is attractive, as these managers usually lack the distribution networks and operational capabilities. These can be provided through partnerships with RMI's mature and more established portfolio companies.

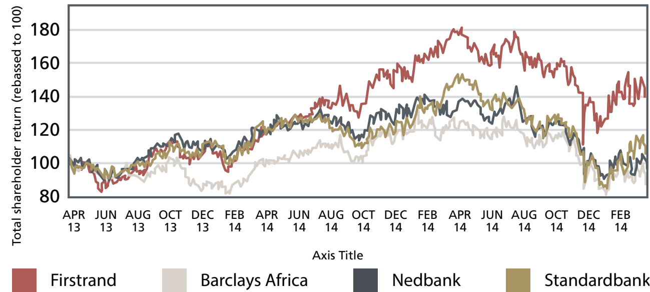
FirstRand

Seventeen percent of Remgro's intrinsic value is currently exposed to FirstRand through an investment in FirstRand and RMH. FirstRand is a good-quality business, leading the big four banks in the country on the majority of key performance indicators relevant to the industry. This has also translated into significant outperformance in its share price.

Equity research



FirstRand vs listed banking



Source: PSG Wealth investment division

Its return on earnings (ROE), which is arguably the most important of these indicators for investors, is well ahead of its peers at 23.4%. However, it remains on a cyclical high and above its target range of 18-22%.

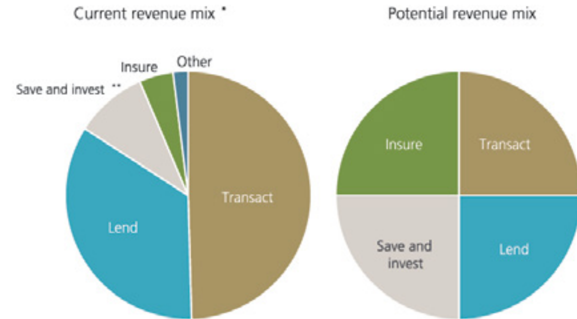
		As at 31 December 2015
Bank	ROE	Target
FirstRand	23.4%	18-22%
Standard Bank	15.3%	15-18%
NedBank	17.0%	*COE + 5%
Barclay Africa	17.0%	18-20%

*COE = Cost of equity

Source: PSG Wealth investment division

The group is not immune to slowing economic conditions, which could lead to more muted lending and transactional activities over the short term. The potential sovereign downgrade to junk status is another significant risk to the industry, affecting both institutional funding costs and the value of government securities held as capital. Against this backdrop, with muted prospects for its traditional lending and transactional businesses, the group has developed a new strategic framework that aims to add new avenues of growth through insurance and investment management. Currently (as indicated by the next graph), only a small portion of the group's revenue is derived from insurance, savings and investments. The company puts forth an attractive case, with extensive cross-selling opportunities to its existing clients in the retail, commercial, corporate and public sectors.

Creation of balanced revenue mix



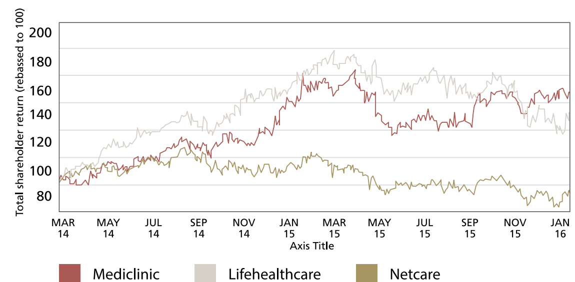
Source: FirstRand Limited

Ashburton will lead its investment management strategy, which will be supplemented through FNB's distribution capabilities and asset class origination. Another arm of the new strategic framework is to grow the business outside of Africa. The initial focus is to extend the vehicle asset finance business in the UK (MotoNovo) and to build a deposit-taking franchise to gain access to hard currency. In conclusion, FirstRand has continually demonstrated a proactive approach to identifying new opportunities to sustain momentum within its operations.

Mediclinic International

Mediclinic is now the group's largest portfolio investment. A 10% move in the share price of Mediclinic translates into a 4% change in Remgro's intrinsic value.

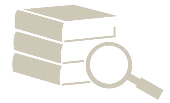
Mediclinic vs listed healthcare



Source: PSG Wealth investment division

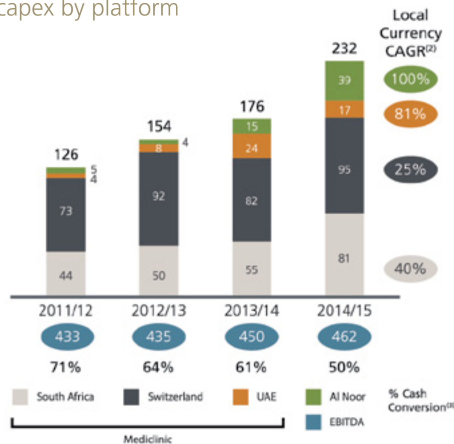
Mediclinic is the largest private medical network provider in the United Arab Emirates (UAE), the largest in

Equity research



Switzerland by revenue and the third-largest private healthcare provider in South Africa. The Al Noor and Spire acquisitions are excellent examples of the active strategy that Remgro's management have adopted. Through the recent reverse merger into Al Noor, the group's main listing moved to the London Stock Exchange, creating one of the largest listed healthcare facility companies on this index. The group was also included in the FTSE 100. Its improved geographic exposure should reduce country-specific legislative risk.

Historic capex by platform



Source: Mediclinic International

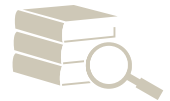
KEY INITIATIVES

SOUTH AFRICA	• Mar -16: Mediclinic Upington (+26 beds) • Oct -16: Mediclinic Bloemfontein (+14 beds) • Oct -16: Mediclinic Emfuleni (+33 beds) • Mar -17: Mediclinic Welkom (+36 beds) • Mar -17: Mediclinic Hoogland (+40 beds) • Mar -18: Mediclinic Medforum (+115 beds) • Mar -18: Mediclinic Potchefstroom (+70 beds)
SWITZERLAND	• Selected acquisitions/ expansions that fit strategic and ROIC criteria
DUBAI	• Development of the North Wing at Mediclinic City Hospital (Q2 2016) • Mediclinic Parkview Hospital (Q4 2018)
ABU DHABI	• Expansion of Airport Road Hospital (2018) • Repositioning and remodelling of Khalifa Street Hospital • Expansion of Al Ain Hospital (28 additional beds by Q1 2016, additional 40 beds expected with new Civic Centre Hospital (opening expected in Q2 2016))

Source: Mediclinic International

- **South Africa:** The South African private hospital market is led by three key players Netcare, Life Healthcare and Mediclinic. Combined, they account for 72% of the private health market. Mediclinic accounts for 22% of the private healthcare market in Southern Africa. A Discovery Health survey found that nine of the 20 best hospitals in South Africa are owned by Mediclinic, illustrating the quality of their local operations. Mediclinic also plans on expanding its footprint further through green field expansions and selected acquisitions. In 2016, Mediclinic Upington, Bloemfontein and Emfuleni will add 26, 14 and 33 beds respectively. Expansion of existing hospitals, the building or acquisition of new hospitals, and opportunities in mental healthcare markets remain key priorities to sustain growth in the face of slowing medical scheme membership. Changes in the medical schemes of government employees and a Competition Commission investigation into pricing in the private healthcare market remain risks locally.
- **Switzerland:** Mediclinic Hirsladen is the largest private medical network in Switzerland, accounting for 33% of the inpatients treated in Swiss private hospitals. Public hospitals hold the majority of the inpatient market share in Switzerland. Mediclinic Hirsladen will focus on the strengthening of outpatient treatments and highly specialised medicine at existing hospitals. Further operating efficiencies are also expected as its operations become more integrated.
- **UAE:** In the Middle East, Mediclinic holds approximately 10% of the market share of the total bed supply in Dubai, and 24% of the private sector bed supply. The increasing incidence of lifestyle-related medical conditions such as diabetes, obesity, cancer and neuropsychiatric conditions are becoming more evident across the UAE. Mediclinic will focus on service gaps in the current healthcare market, particularly obstetrics, gynaecology, paediatrics, neonatology, cardiology and oncology. The recent Al Noor acquisition expanded Mediclinic's presence even further in the UAE. Al Noor is the largest integrated private healthcare provider in Abu Dhabi, with a growing presence in the UAE and Oman. Al Noor is the market leader in both the inpatient and

Equity research



outpatient market in Abu Dhabi, holding 29% and 30% of local market share respectively.

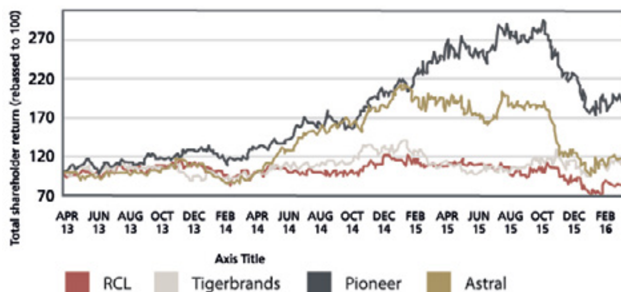
- **UK:** The group has a 29.9% investment in Spire Healthcare, which is listed on the London Stock Exchange. Spire is the second-largest operator in the UK, with 38 hospitals. Its four key competitors include BMI Healthcare (which is owned by Netcare), Nuffield, Ramsay and HCA. The group will focus on increasing acuity services in hospitals and the development of new sites and services, with particular focus on geographic diversification and the treatment of cancer.

Investments into the hospital industry are normally lower-risk investments due to the industry's defensive nature and high barriers to entry. The group continues to invest in beds on the back of an aging population and an increase in the incidence and severity of diseases. Management indicated that they will continue to evaluate further growth opportunities across platforms for the delivery of effective quality healthcare. The group's focus on top-end customers willing to pay for the best healthcare should further support the resilience of patient volumes. The increase in the group's scale should also support operating efficiencies through procurement synergies.

RCL Foods

RCL Foods (RCL) has been the laggard in the group's portfolio, but has undergone transformational acquisitions over the last three years. The RCL investment contributes 5% to the group's intrinsic value.

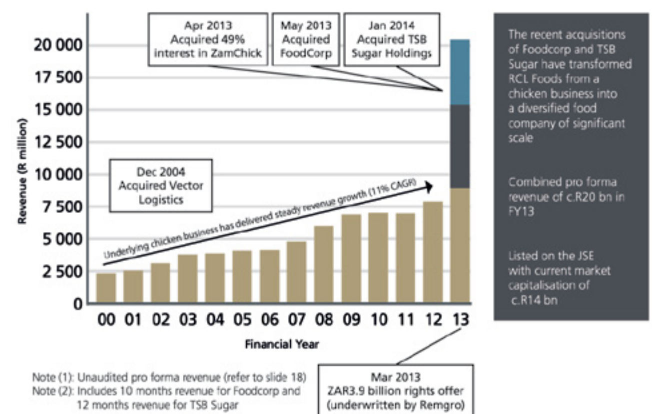
RCL Foods vs listed food producers



Source: PSG Wealth investment division

Foodcorp and TSB Sugar, more recent acquisitions, have transformed RCL from a chicken business into a sizable diversified food manufacturer and distributor that is geared for growth.

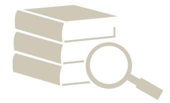
History and evolution



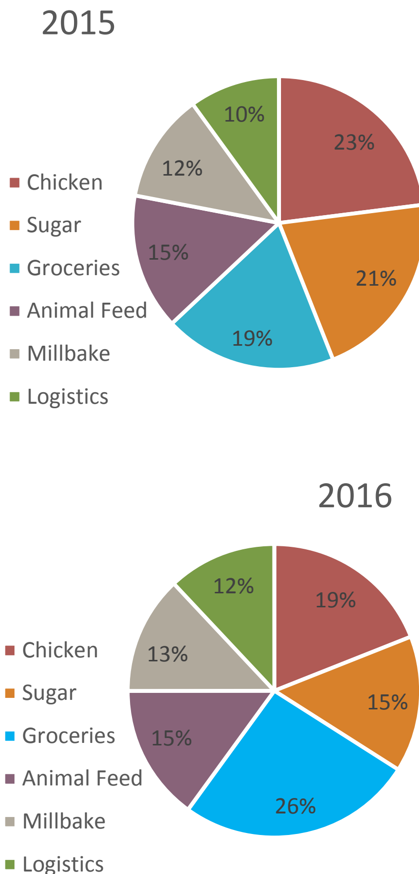
Source: RCL Foods Limited

These acquisitions represented an attractive opportunity for RCL to expand its portfolio of branded products and diversify revenue streams to help mitigate the cyclical nature of the chicken industry. RCL also made sizeable investments into the expansion of factories and milling capacity at Foodcorp, enabling greater product innovation. The TSB acquisition also provides RCL with an opportunity to establish an attractive, well-capitalised agri-foods platform for future opportunities in sub-Saharan Africa. RCL will continue to explore further low-risk entry points into Africa. RCL's target is for the rest of Africa to contribute 10% to overall revenue by 2020. In line with the RCL strategy towards a more balanced portfolio, the relative share of earnings before interest, taxes, depreciation and amortisation (EBITDA) is now more balanced.

Equity research



Relative share of EBITDA



Source: RCL Foods Limited

These acquisitions also provided RCL with the opportunity to leverage Vector's business model, skills and expertise. Through Vector Logistics, RCL recently acquired a 49% stake in Senn Food Logistics, the largest cold distribution chain in Botswana. This should support the group's African expansion strategy. To a large extent, the group's combined performance continues to be dictated by maize and other commodity prices, which are inherently volatile and beyond management's control. The enlarged group has significant potential for expansion, with a solid distribution platform, improved group efficiencies and the opportunity to expand into new categories with improved value-added products.

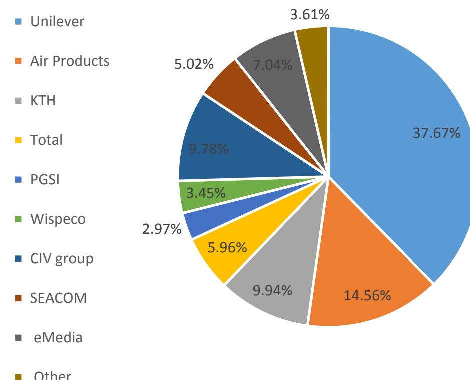
Distell

Distell currently contributes 7% to Remgro's intrinsic value. Distell recently adopted a new corporate strategy, with a focus on expanding the business in Africa and specific international markets. As a part of the strategy, the offshore business has been altering its route-to-market to move away from a pure export model. The reason for this shift is to move the operations closer to the end consumer, which enables the business to grow its market coverage and compete more effectively against global players. Distell has been investing heavily in regional sales teams in order to execute this strategy. Despite pursing these new objectives the company will continue to maintain its investment in its brands. In line with industry trends, Distell has directed additional efforts to growing its premium products to capture growth from changing consumer preferences.

Unlisted portfolio

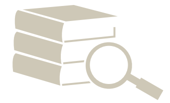
Remgro has a quality industrial portfolio. The portfolio is dominated by Unilever in the food segment, Air Products and KTH in the industrial segment, and CIV Group and Seacom in the infrastructure segment. The unlisted portfolio currently contributes 16% to Remgro's intrinsic value.

Unlisted Investments



Source: PSG Wealth investment division

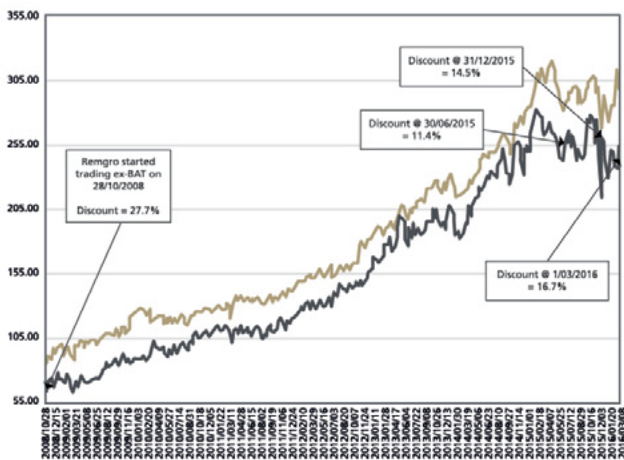
Equity research



Holding discount

The 16% discount that the group is trading at relative to its intrinsic value, is on the higher end of its five-year historical average.

History and evolution



Source: Remgro Limited

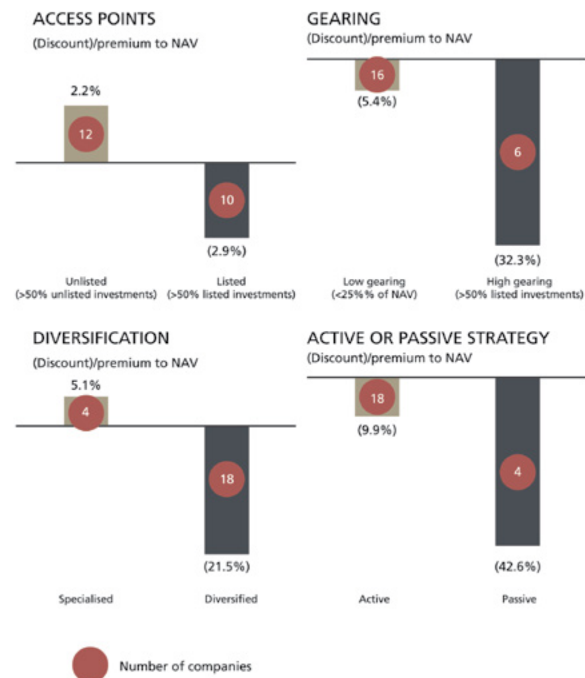
We believe this discount is more likely to continue narrowing over the next few years. Estimating the correct holding company discount depends on a number of factors. In South Africa, holding company discounts vary widely from company to company.

Local investment holding company discount				
Share	Date	Share price	Intrinsic value	Discount
Reinet	31 Dec 2015	3188	4561	-30.1%
RMBH	31 Dec 2015	5561	5658	-1.7%
Sabvest	31 Dec 2015	3485	3719	-6.3%
Blackstar	31 Dec 2015	880	1650	-46.7%

Source: PSG Wealth investment division

Given the increase in Remgro's international shareholder base over time, it is relevant to consider the discount applied to similar international investment holding companies by these investors. Analysis of comparable investment holding companies have revealed the following trends:

Comparable investment holding company discounts

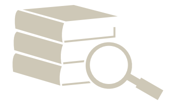


Source: RMI Holdings, The Boston Consulting Group

Factors identified supporting an above-average discount to intrinsic value:

- Access points: Investors can invest in the group (Remgro) or its seven listed companies (investees). This is supportive of the discount that the group trades at relative to its intrinsic value.
- Wide diversification: Although management has significantly improved the group's focus over the last 10 years, it is still widely diversified. It has a 40% exposure to healthcare investments, 32% to financial services, and food, industrial, infrastructure and media investments contribute the remainder. It can be argued that the group's wide diversification is the primary contributor to the discount it trades at relative to its intrinsic value.

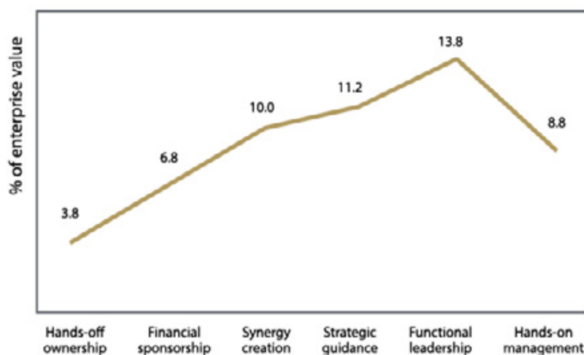
Equity research



Factors supporting a below-average discount to intrinsic value:

- Gearing: Highly geared holding companies tend to attract higher discounts to their intrinsic values from the market. Remgro traditionally had surplus cash on its balance sheet. This was a drag on investment performance but its capital structure improved following corporate activity from Mediclinic.
- Active strategy: Research suggests that the level of value creation by holding companies increases with the degree of parent involvement up to the point of hands-on investment, when the value-add gets reduced.

Holding company net value added



Source: The Boston Consulting Group

The value created by Remgro's decentralised strategy, with its involvement concentrated mainly on the provision of support, rather than on being involved in the day-to-day management of business units, is supportive of a lower discount relative to passive holding companies and hands-on holding companies.

Conclusion

Remgro is a solid, diversified company with a reasonably low risk profile and a proven track record of unlocking shareholder value. We feel the share is exposed to high-quality, sector-leading financial and industrial investments, combined with shareholder-aligned management teams. We feel the investee companies have credible growth prospects, which is enticing in a low growth environment.

The share should be valued at the market value of its investments. We estimate that the group's intrinsic net asset value as on 7 April was approximately 29 000cps. The group's listed investments contribute 84% of its portfolio's intrinsic value, of which Mediclinic is the largest at 40%. Growth from Mediclinic will most likely be the driver of share price performance, given its size in the portfolio and the opportunities available to it. Given the large listed component of Remgro's portfolio, equity market performance remains a significant contributor to movements in intrinsic value in the short term. The current discount to intrinsic value of 16% is at the upper-end of its historical average. We feel that this discount should narrow over time given the group's proactive stance in managing its investments and the removal of the cash drag on its balance sheet.

Given the large domestic component of its portfolio, the weak local economy and the probable sovereign downgrade is likely to impact its share price. This should, to a certain extent, be negated by the increasing international profile of its investments.

The group's balance sheet is not highly geared, enabling it to support its investees to grow through acquisitive means.

Fixed income

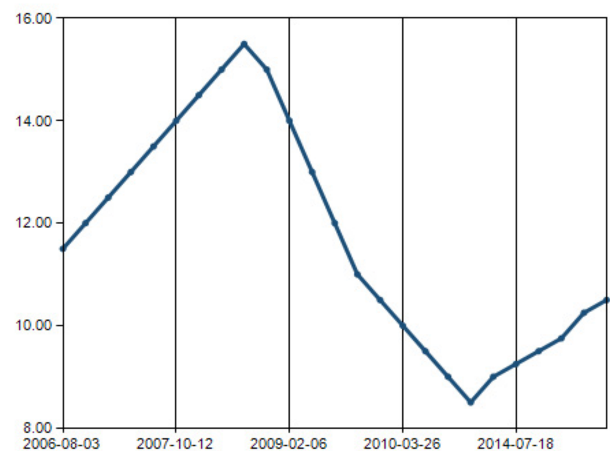
Ahead of imminent policy normalisation by the American Federal Reserve (Fed), the Monetary Policy Committee (MPC) of the South African Reserve Bank (SARB) continued with small incremental increases in official short-term interest rates.

Repo rate increases since 2006

Year	Day & Month	Value
2016	18 March	10.50
	29 January	10.25
2015	20 November	9.75
	24 July	9.50
2014	18 July	9.25
	31 January	9.00
2012	20 July	8.50
2010	19 November	9.00
	10 September	9.50
	26 March	10.00
2009	14 August	10.50
	29 May	11.00
	4 May	12.00
	25 March	13.00
	6 February	14.00
2008	12 December	15.00
	13 June	15.50
	11 April	15.00
2007	7 December	14.50
	12 October	14.00
	17 August	13.50
	8 July	13.00
2006	8 December	12.50
	12 October	12.00
	3 August	11.50

Source: South African Reserve Bank

South African repo rate



Source: South African Reserve Bank

Rate normalisation is expected to continue

Although rate normalisation has been topical for some time, the official short-term interest rate has actually only increased by 2.00% since July 2012. At that stage rates were at 30-year lows of about 8.50%. Rate increases have been relatively frequent recently. However, given the quantum of the move over time, the MPC's commitment to consider consumers while still following its mandate to fight inflation remained clear from its decisions. What is interesting to note is that the repo rate is now at 10.50% – the same level it was at in August 2009. At that stage the MPC was allied with a very accommodative monetary policy, following the strain placed on the economy during the global financial crisis. From June 2008 to August 2009, interest rates were slashed by 5.00% from 15.50% to 10.50%.

In this context, we believe rate normalisation is inevitable over the medium term. Although rates are higher than what we have experienced over the recent past, they still remain unsustainably low.

Fixed income

We therefore expect the MPC to continue with small incremental rate increases in the coming quarters. At the start of the year there was a risk that rates would be increased more aggressively, especially given the weakness of the rand. We think this risk has largely been muted due to a stronger rand in recent months.

We expect the rising interest rate cycle to have a negative impact on more flexible, negatively correlated fixed interest instruments like bonds, preference shares and property income assets. However, given our expectations that these moves will be small, protracted and reasonably anticipated, we don't expect the impact of these individual hikes to contribute excessive amounts of volatility to capital markets.

The cost of capital will, however, continue to rise, as interest rates increase and bond yields adjust accordingly. In addition, recent profile changes to sovereign debt will also negatively impact the cost of capital. We think most of the immediate effects of a potential downgrade of sovereign debt are already reflected in asset prices. However, we are cognisant of a 'second-round effect', which may take place. What the costs of this second round may be, remain uncertain. Therefore we encourage investors to tread lightly when perusing investments which seem too good to be true.

Positioning investments for uncertainty

We believe now is the time to place a higher value on both liquidity and quality. There are many unknowns in the prevailing market conditions, therefore a degree of quality and manoeuvrability are essential components of an investment strategy. We will continue to assess the value-to-risk of investment opportunities as and when they present themselves, and will accordingly make adjustments to our solutions.

Based on our 2016 forecasts, the Taylor rule describes an average target prime rate of 11.25%, up from the current rate of 10.5%. These targets are based on a forecasted average CPI north of 6%. Our conservative forecast for the prime rate is that it could reach a level of 11.50% by the end of 2016. This is roughly in line with the percentage described by the rule. Given the poor growth outlook for the year ahead, it's unlikely the rate will overshoot drastically.

Our positioning

Metric	Position	Direction	Reasoning
Modified duration	Underweight	-	Interest rate risk
Credit risk	Underweight	-	Deteriorating domestic economic climate
SA cash	Overweight	+	Reducing opportunity cost
SA sovereign debt	Underweight		Negative economic outlook by rating agencies
Nominal bonds (1-3 years)	Overweight		Due to underweight positioning in longer-dated bonds
Nominal bonds (3-7 years)	Underweight		Prefer cash
Nominal bonds (7+ years)	Underweight		Reducing interest rate risk
Inflation-linked bonds	Overweight	-	Stronger rand expected over medium term

Source: PSG Wealth investment division

Given the conditions mentioned above, we are in favour of an overweight position in cash, an underweight position in longer-dated nominal bonds and a preference for high-quality debt.

PSG Wealth

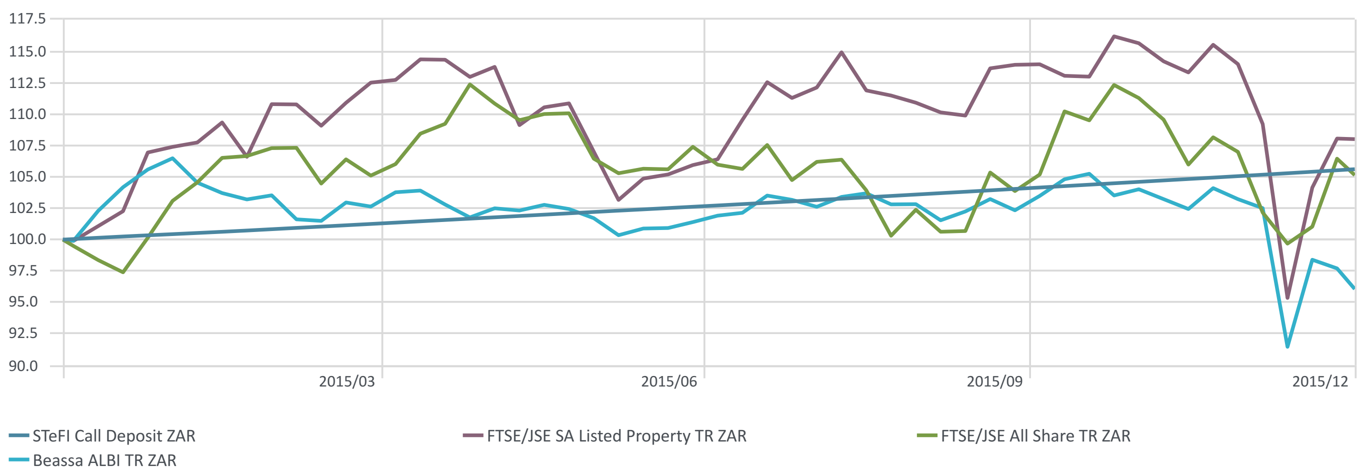
Property commentary

The first quarter of 2016 was a busy one for the local real estate sector. The year started off with similar levels of volatility and uncertainty as seen in 2015. As predicted in our previous issue, local listed property returns took their direction from capital markets and followed suit. However, as our local reporting season kicked off in February, returns started to take direction from the strong real estate fundamentals reported in this period.

The South African Listed Property Index (SAPY) made a tremendous recovery, ending the quarter up more than 10%. The rand recovered, breaching below the R15-level against the dollar for the first time since December 2015. Bond yields came down considerably, strengthening by 64bps to end the quarter at 9.13% (31 December 2015: 9.77%). The latest financial communication reflected decent operating performances from the majority of local counters. We continue to remain cautious on valuations given the current state of property fundamentals in South Africa. While changes in capital markets may drive short term performance, we maintain our view that real estate fundamentals will drive performances over the long run.

INVESTMENT GROWTH

Time period: 2015/01/01 to 2015/12/31



The SAPY returned 10.1% for the quarter, significantly outperforming equities (3.87%), bonds (6.55%) and cash (1.53%). The strong performance can be attributed to lower bond yields and decent results from the companies that reported in the first quarter. It is worth noting the widening in yield spreads between government long-term bonds (R186) and the SAPY (excl. non-dividend paying and 100% offshore earnings focused companies) - widening from -1.86% in January to -2.49% in March illustrating the rerating in the sector.

REPORTING SEASON

The reporting season kicked off in February, with most companies reporting either half- or full-year results. Despite South Africa's bleak economic outlook some companies still managed to declare distribution growth in the double-digits. (See some of the reported results in the table on page 43).

Property commentary

Company	Market cap in rands	Reporting period	DPS growth	NAV growth
Intu Properties	84 848 161	Full year	0.0%	6.6%
NEPI	55 627 422	Full year	9.70%	10.8%
Resilient	53 148 797	Interim	25.2%	31.2%
Fortress-B	35 633 776	Interim	101.2%	100.5%
Rockcastle	34 494 016	Full year	8.2%	4.0%
Fortress-A	17 260 531	Interim	4.8%	2.3%
SA Corporate	11 345 025	Full year	10.8%	14.4%
Emira	7 933 948	Interim	8.8%	2.9%
Texton	3 140 157	Interim	15.3%	-6.9%
Tower	1 951 655	Interim	7.6%	3.7%
Hospitality A	1 522 212	Interim	5.0%	9.1%
Hospitality B	434 299	Interim	85.0%	9.1%
Attacq	15 091 063	Interim	-	24.5%
Fairvest	993 975	Interim	10.0%	15.6%
Hyprop	29 297 763	Interim	13.4%	15.8%
Growthpoint	66 346 374	Interim	6%	9.0%
Capco	58 930 806	Full year	0.0%	16.1%

Source: Catalyst Fund Managers, Company Financial Results, PSG Online

The strong growth in distributions was mainly a function of positive retail rental growth (the office sector is still under pressure) and contractual escalations. Those companies with earnings exposed to offshore assets also benefitted from the rand's devaluation against the currencies of major developed countries.

Corporate activity

Hyprop and Redefine became the latest supporters of the growing trend amongst local property companies to diversify their assets offshore. In early February, Hyprop made its first foray into Eastern Europe after acquiring two shopping malls in Serbia and Montenegro for a total purchase consideration of €203m. Then in early March, Redefine made a bold move into Poland (also Eastern Europe) by acquiring a 75% stake in Echo Prime Properties, which consists of 18 high-yielding commercial properties worth €1.2bn. The deal marks one of South Africa's largest real estate transactions to date and will expand Redefine's offshore exposure beyond that of the UK and Australia, where it owns significant stakes in Redefine International (30.1%) and Cromwell (25.6%). The deal will be financed through offshore debt facilities to take advantage of the low interest rate environment in Poland. This is the second domestically listed property company to make its way into the Polish market, after Rockcastle acquired two shopping centres in Southern Poland in December 2015.

Best performers

The top 10 best performing listed property companies were dominated by the hybrid property stocks (local and offshore exposure), as opposed to the 100% rand-hedged stocks which topped the list in the previous year. Redefine Properties (+23.5%) was the front runner for the first quarter as investors welcomed its entry into Eastern Europe. One should note that the stock is coming off a low base, having been one of the worst performers in December's massive sell-off. Amongst the top performers are the likes of Resilient and Hyprop, which reported solid results during the period.

Property commentary

Capital & Counties (Capco with -31.7%) bottomed the list for the first quarter. This was as fears surrounding the potential exit by Britain from the European Union (the so-called Brexit) and an appreciating rand against the sterling (up 8.1% over the period) negatively impacted the performances of UK-focused property companies.

Top 10 listed property shares for the year:

Rank	Company	Q1 Return (Cumulative)
1	Redefine Properties Ltd	23.51%
2	Resilient REIT Ltd	19.57%
3	Stenprop Ltd	18.24%
4	Hyprop Investments Ltd	16.74%
5	New Frontier Properties Ltd	13.04%
6	Hospitality Property Fund Ltd Class B	12.72%
7	Hospitality Property Fund Ltd Class A	11.56%
8	Dipula Income Fund Ltd Class A	11.22%
9	Growthpoint Properties Ltd	9.62%
10	SA Corporate Real Estate Fund	9.33%

Source: Morningstar Direct

Global listed property

The FTSE EPRAN/NAREIT Developed Rental Index recorded a net total USD return of 6.32% for the first quarter of 2016. Japan topped the log for the best performing listed real estate market, which recorded a total return of 18.43% (in USD), while the UK was the worst-performing listed real estate market, returning a negative 8.99% (in USD) over the same period.

Macro-economic factors played a leading role in the performances of global listed real estate during the first quarter of 2016. The Bank of Japan surprised markets in January by adopting negative interest rates to help spur growth in an already crippled global economy. The decision led to a Japanese bond buying spree, sending government bond yields below zero for the first time in Japan's history. As a result, Japanese listed real estate stocks rallied. Then in March, European listed real estate topped the log as the best performer, after the European Central Bank announced a further interest rate cut (interest rates are now sitting at negative 0.4%) and a 33% increase (from €60bn to €80bn) in monthly bond purchases, which will now include investment grade corporate bonds.

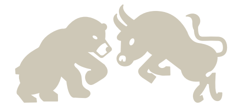
The underperformance of UK listed real estate can largely be attributed to the uncertainty surrounding the EU-referendum, scheduled to take place on 23 June. According to Catalyst Fund Managers, property companies with exposure to London's office space have been hit the hardest.

Positioning

We remain of the view that the interest rate cycle will impact domestic economic strength, affordability and sentiment. In addition, other income-generating assets with positive correlations to interest rates will become increasingly attractive, placing further downward pressure on listed property. Where we are required by mandate to hold listed property, we prefer to hold counters with the following characteristics:

- low price-to-book values
- low levels of debt/gearing and strong credit ratings
- globally diversified portfolios, or counters that generate earnings abroad (like New Europe Property Investments plc, Rockcastle, New Frontier, Capco, Intu, MAS, Sirius, Redefine International and Investec Australia)
- utilisation of structures that offer superior liquidity, like real estate investment trusts (REITs)
- superior distribution growth track records.

Preference shares



The FTSE/JSE Preference Share Index generated a gain of 4.6% (total return) during the first quarter of 2016. This follows the marginal loss of 1.0% during the fourth quarter of 2015. The recent push was welcomed by investors, given that the total return for 2015 came in at 2.6%. The rolling 12-month total return at the end of this quarter was a reasonably healthy 8.7%.

Returns on income orientated asset classes

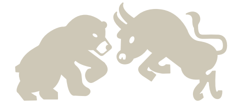
	1 month	3 months	6 months	1 year
Beassa 1-3 Yr TR ZAR	1.3	3.2	2.7	5.6
Beassa 7-12 Yr TR ZAR	2.7	6.7	0.5	0.3
FTSE/JSE Preference Share TR ZAR	4.6	4.6	1.8	8.7
FTSE/JSE SA Listed Property TR ZAR	9.5	10.1	5.0	4.6
STeFI 6 Month NCD ZAR	0.5	1.5	3.0	5.9

Source: i-Net
*Performance reported in base currency and indicate total return. Returns of periods exceeding one year have been annualised.

Although issued yields expressed as a percentage of prime are generally below the prime rate, current effective yields (yield over clean price) are generally above prime at 10.50%, due to lower prevailing clean prices.

PSG Wealth

Preference shares



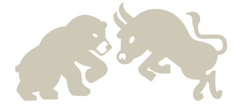
Domestic preference shares characteristics

4/4/2016	Standard	ABSA	FirstRand	Nedbank	Inv Ltd	Inv Bank	Inv Pref	Capitec	Sasfin
Value	SBPP	ABSP	FSRP	NBKP	INPR	INLP	INPPR	CPIP	SFNP
Price (R)	82.55	735.00	77.50	8.45	73.20	78.60	83.00	86.90	78.00
Quoted yield as % of prime @10.50%	77.00	70.00	75.56	83.33	77.78	83.33	95.00	83.33	82.50
Dividends	Non-cum	Non-cum	Non-cum	Non-cum	Non-cum	Non-cum	Non-cum	Non-cum	Non-cum
Accrued dividends	4.50	-	0.75	0.03	2.70	2.89	3.29	0.43	4.22
Clean price	78.05	735.00	76.75	8.42	70.50	75.71	79.71	86.47	73.78
Liquidity	SBPP	ABSP	FSRP	NBKP	INPR	INLP	INPPR	CPIP	SFNP
Market cap (Rm)	4 374	3 634	3 488	3 029	2 358	1 214	189	174	145
Avg monthly trade (Rm)	55.90	41.39	47.66	42.86	27.94	21.74	8.11	3.51	4.00
% of market cap traded monthly	1.28	1.14	1.37	1.42	1.18	1.79	4.29	2.01	2.77
Yield as a % of prime	98.65	95.24	98.45	98.93	110.32	110.07	119.19	96.37	111.82
Effective yield	10.36	10.00	10.34	10.39	11.58	11.56	12.51	10.12	11.74

Source: Grindrod Bank

PSG Wealth

Preference shares

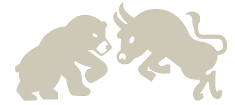


Domestic preference shares characteristics

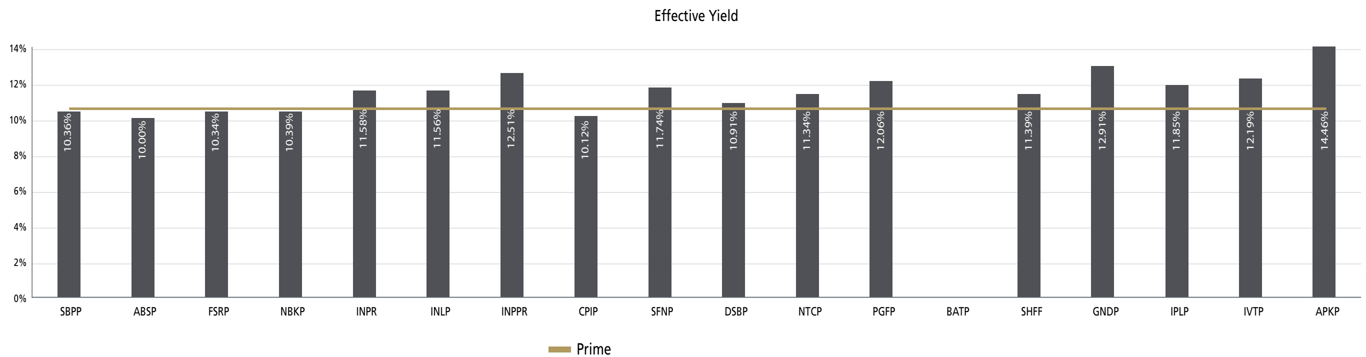
4/4/2016	Discovery	Netcare	PSG	Steinhoff	Grinrod	Imperial	Invicta	Astrapark
Value	DSBP	NTCP	PGFP	SHFF	GNDP	IPLP	IVTP	APKP
Price	97.00	80.00	73.01	80.00	72.00	73.50	91.75	65.00
Quoted yield as % of prime @10.50%	100.00	82.50	83.33	82.50	88.00	82.50	102.00	88.89
Dividends	Non-cum	Cum	Cum	Cum	Cum	Cum	Cum	Cum
Accrued dividends	0.80	3.62	0.43	3.92	0.46	0.43	3.92	0.46
Clean price	96.20	76.38	72.58	76.08	71.54	73.07	87.83	64.54
Liquidity	DSBP	NTCP	PGFP	SHFF	GNDP	IPLP	IVTP	APKP
Market cap (Rm)	776	520	1 272	1 200	533	334	688	98
Avg monthly trade (Rm)	7.30	7.51	16.84	21.10	9.92	4.84	10.83	1.88
% of market cap traded monthly	0.94	1.45	1.32	1.76	1.86	1.45	1.57	1.93
Yield as a % of prime	103.95	108.01	114.82	108.44	123.00	112.90	116.13	137.73
Effective yield	10.91	11.34	12.06	11.39	12.91	11.85	12.19	14.46

Source: Grindrod Bank

Preference shares



Effective yield



Source: PSG Wealth investment division

Current risks for preferences shares

Although preferences shares can be seen as suitable income-generating investments for some high-net-worth investors, and although prime-linked yields are set to increase as interest rates increase, we feel that there are some significant capital risks in this asset class.

With the domestic economy struggling, further downgrades to any South African sovereign ratings, local banks or state-owned enterprises that are guaranteed by the South African government become increasingly likely. If this happens, large international institutional investors and passive investment funds may be compelled to exit these markets. This will drive yields higher and will put capital values of preference shares under pressure.

In addition, liquidity is an investment characteristic that we don't easily sacrifice, as it often places an investor in the position of price-taker when fundamental asset values are skewed disproportionally to what can be obtained in the open market.

Banking preferences and Basel III

Basel III capital adequacy requirements stipulate that banks must hold specified minimum amounts of capital in their tier 1 common equity, as set out by the South African Reserve Bank (SARB). The existing preference share listing documents of South African banks currently do not satisfy the requirements under Basel III. However, the SARB has allowed a 'grandfathering' period during which preference shares allocated towards tier 1 capital will be reduced by 10% per annum (currently 70%).

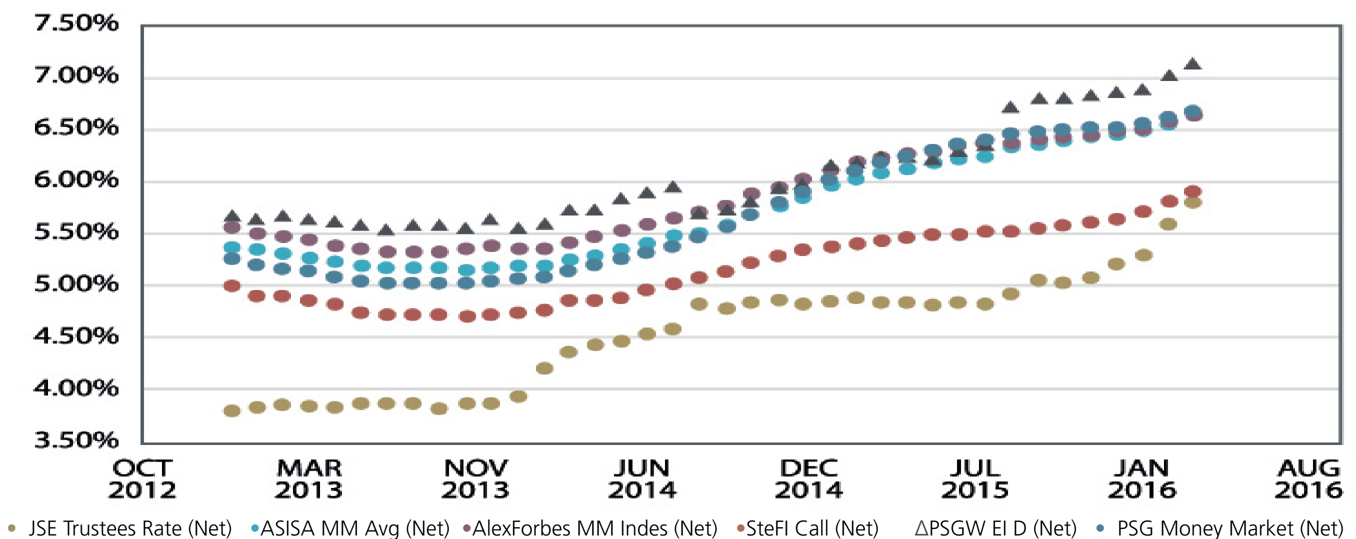
It remains to be seen whether the banks will elect to repurchase their preference shares in the open market, or incentivise investors to accommodate any changes to the legal risks in the listing documents.

PSG Wealth

Cash management options

The effective after-cost yields for both the PSG Wealth Enhanced Interest Fund (7.09%) and the PSG Money Market Fund (6.63%) are currently above the SteFI call rate (5.85%). These numbers are also higher than the average yield of the ASISA Money Market Fund peer group (6.60%).

Rate Comparison (Net of fees)



Source: PSG Wealth investment division, Morningstar, JSE, Investec.

Attractive current cash management options

Both these funds invest only in investment-grade instruments and are Regulation 28 compliant. The PSG Money Market Fund retains a slightly shorter duration as required by its fund classification and mandate. The PSG Wealth Enhanced Interest Fund's mandate maintains a slightly higher duration profile to enhance yield.

The JSE Trustees rate (net 5.75%) increased sharply over recent months and offers a reasonable yield for investors who wish to keep cash in their stockbroking accounts. This will enable them to act swiftly if, and when, equity investment opportunities present themselves.

Cash is becoming increasingly attractive as interest rates rise

During our previous quarterly review we mentioned that the South African forward rate (FRA) curve was pricing in rate hikes totalling 0.75% over the next two Monetary Policy Committee (MPC) meetings. The last MPC meeting was concluded on 17 March and these estimates were spot on, as the MPC raised rates by 50 basis points in January and a further 25 basis points in March. With inflation statistics currently surpassing earlier forecasts, we expect a further interest rate hike over the coming quarter. The MPC will likely increase interest rates by a further 25 basis points on 19 May. At this stage money market FRAs indicate that a three-month fixed deposit could yield 7.8% in nine months' time. This implies that the money market is expecting rate increases of about 0.75% over the same period. This validates our view that cash is becoming an increasingly appetising investment option for our multi-asset funds.

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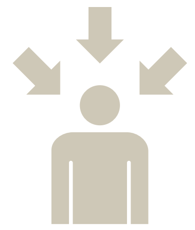


Theme spotlight

Chinese economy going through growing pains

China's recent economic slowdown has pushed the world's second-largest economy to attempt a Western capitalist approach, similar to the economic policies used by the former US president Ronald Reagan in the 80s.

The search for new havens for emerging market assets

In 1981 the US was undergoing stagflation – unemployment and inflation was rising at the same time, making it impossible to address either problem without leading to a downward economic spiral. To combat the problem Reagan proposed four solutions:

- Supply-side economics or the 'trickle-down theory'. The basic premise here was that by giving massive tax cuts, people would have more money left over to invest in the economy. Under Reagan, wealthy Americans went from paying about 70% in taxes to 28%.
- The second idea was to deregulate government oversight in economic price fixing, implemented by previous presidents. Most notably, Reagan removed restrictions on the banking industry, leading to a situation mirrored by the 2008 financial crisis. Banks began to invest in risky unbacked real estate, and when these investments failed, so too did half of the banks in the US. This lead to the 1989 savings and loans crisis. Similar to 2008, failed banks were also bailed out.
- Reagan gutted government services, particularly regulatory and oversight agencies. This was done to offset the massive tax breaks. Many economists are of the opinion that this strategy might have worked, if it weren't for Reagan's fourth plan…
- From 1980 to 1986, the threat of an attack by the Soviet Union led Reagan to double defence spending. By 1989 it reached nearly a quarter of the total federal budget of the US.

Did these policies work for America?

For the first two years of Reagan's term, the country fell into a recession. But after interest rates were adjusted and 'Reaganomics' went into play, the US saw a brief period of healthy growth. Americans had more money after tax cuts, industries flourished without oversight and the military cemented America's powerful position abroad. However, the huge losses in tax revenue coupled with massive increases in military spending led to the national debt of the US jumping from $900 billion in 1980 to more than $3 trillion by 1990. Many of Reagan's policies were continued by the next two Republican presidents, George Bush senior and junior, pushing the US deficit to roughly $10 trillion by 2008.

Today, after decades of 'Reaganomics', many are pointing to the disappearing middle-class, incredibly wealthy 1% and overly powerful military as being a result of those policies. Similarly, radical deregulation of US financial markets by George W. Bush has been pointed to as one of the biggest catalysts of the 2008 global economic crisis. And despite a slow and steady recovery from that crisis, only wealthy Americans have seen any real growth, while regular wages are stagnant in the rest of America.

Similar policies are on the cards for China

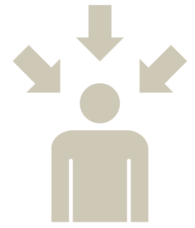
As China grapples with its own economic issues, Chinese president Xi Jinping announced that the country would focus on supply-side reforms such as cutting taxes and red tape, similar to those implemented by 'Reaganomics'.

Top Chinese leaders set five tasks in December to bolster the slowing economy and come up with a new growth model. The tasks are:

- cutting industrial overcapacity
- reducing surpluses in the property sector
- deleveraging
- lowering corporate costs
- 'improving weak links' or bottlenecks in the economy

Everybody is aware of the impact China has on the world economy, mainly due to its size. We have already seen commodities and stock markets plummet as a

Theme spotlight

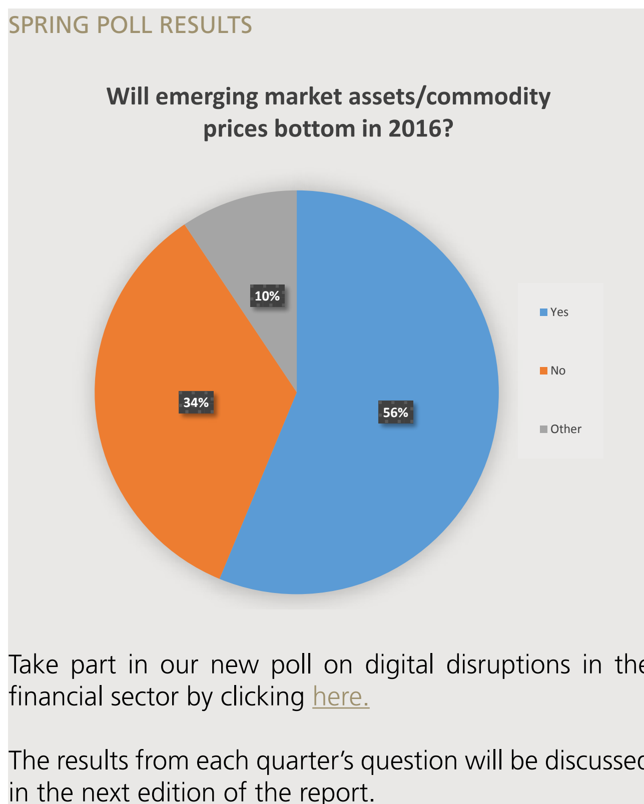


result of its economic slowdown, and this causes one to question whether its economy can survive and prosper – or whether total economic collapse is possible.

Pressure on Chinese growth and commodity prices

More than half of the readers we polled in the last edition of the PSG Wealth Investment Research and Strategy Report think that emerging market assets/commodity prices will, or have already, bottomed this year. (See the results of the Spring poll in the box below.)

SPRING POLL RESULTS



Take part in our new poll on digital disruptions in the financial sector by clicking here.

The results from each quarter's question will be discussed in the next edition of the report.

The price of commodities have always followed a cyclical pattern of supply and demand. On the demand side, weaker world growth is weighing on commodity prices, especially industrial commodities tied to business cycles and industrial development.

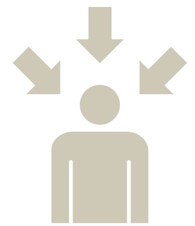
And although China has represented much of the demand-side inflation of commodities in the past few decades, the supply-side could also influence the price of these emerging market assets.

The strong dollar is also contributing to lower commodity prices, exacerbating powerful shifts in commodity market supply and demand dynamics.

Meanwhile, the supply side is characterised by significant excess capacity installed during the boom years, which will persist until enough marginal producers suspend production. In this context, commodity prices have been depressed, with the Bloomberg Commodity Index reaching a new low in January 2016 before recovering somewhat in February and March. Theoretically, falling commodity prices should redistribute, but not reduce world income. Commodity exporters suffer declining revenues but their loss is an equal gain for importers. However, the growth response in commodity-importing economies appears to have been relatively weak, as consumption remains subdued. Low commodity prices have also put downward pressure on inflation in most economies, contributing to unusually mild world inflation. The exceptions to this rule tends to be commodity exporters where currency depreciation has in some cases generated higher inflation. Much lower commodity prices have also been an important factor in the slowdown of world trade, now at levels normally seen in global recessions. Global growth forecasts continue to show world growth rebounding over the forecast horizon. Such projections, however, have repeatedly fallen short over the past five years, and there are significant downside risks to growth, particularly from emerging markets.

The commodity price cycle can turn if demand for commodities pick up, which many still believe is dependent on demand from China.

However, data from the first quarter of this year suggests that the Chinese economy might not reach the exceptional growth levels previously seen – which supported the demand for emerging market commodities.

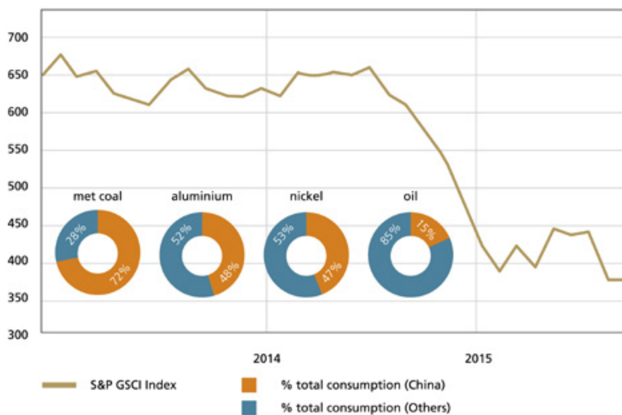


Theme spotlight

After 30 years of rapid economic growth, China's growth rate has been slowing down. According to Trading Economics, China's GDP growth rate fell to around 6.9% in 2015, the weakest since 1990. Secondary industry (manufacturing) growth slowed to 6% in 2015 from 7.3% in 2014, and the services sector expanded by 8.3% - higher than the 7.8% expansion in 2014.

To address the cooling of the economy, which logged its lowest annual expansion in a quarter of a century, China has cut benchmark interest rates and the reserve requirement ratio of banks several times since 2014.

Chinese consumption of commodities



Source: World Bank

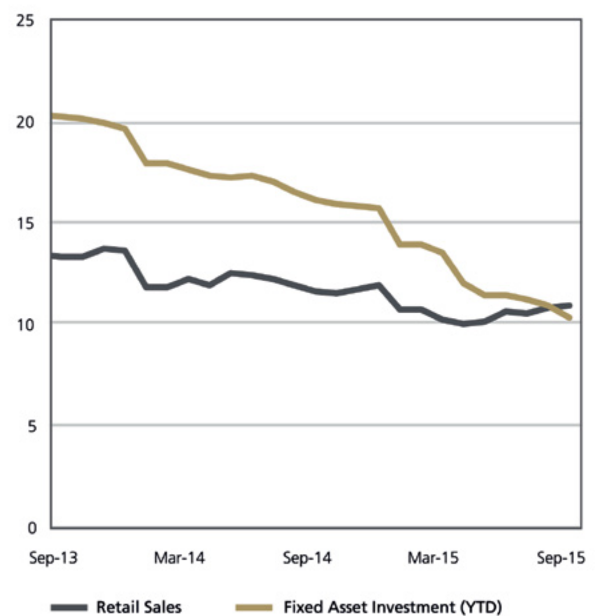
Unreliable growth statistics out of China

Recent economic data suggests that policy support is starting to feed into the Chinese economy as growth in fixed asset investments picked up in the January-February period. According to Trading Economics, investment in fixed assets (excluding rural households) grew by 10% in 2015 (2.9 percentage points slower than the year before) and accounted for 36.1% of GDP. Investment by state holding enterprises increased by 10.9%, while private investment went up by 10.1%, accounting for 64.2% of the total investment. This shows that investment is gradually recovering on the back of healthier dynamics in the property sector and stronger public investment.

However, many global investors have lost faith in the truth of GDP figures reported by China's National Bureau of Statistics. Gordon Chang, a peripatetic and knowledgeable observer of the region who also writes for *Forbes Magazine* and *World Affairs*, told a financial blogger on *Enterprise Investor* that there's a consensus forming that China's GDP growth rate is closer to around 4%.

Chang comments: "For instance, you have the Conference Board reporting 3.7% growth for last year. Capital Economics in London is saying 4.3%. Although, you can make a case for 1% or 2%, especially when you look at electricity consumption, which is still by far the most reliable indicator of Chinese economic activity, and when you look at price data. For instance, for last year, when they were reporting 6.9% real, they were also reporting 6.4% nominal."

Chinese consumption versus investment



Source: World Bank

A downward trajectory

However, Chang feels that it doesn't really matter what China's growth rate is, whether it's 6.9% or 1%. "The point right now is that Chinese leaders cannot change the downward trajectory. China's growth has been slowing fast. It's going to continue to do that. Eventually,

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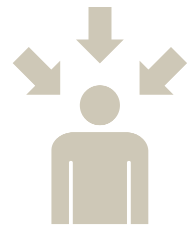
Theme spotlight



it's going to go into contraction, and that's a problem because China has accumulated all this debt in order to create growth. In some way, it's got to pay this debt back. In one way or another, it's got to retire these obligations. This means that China's headed towards a debt crisis."

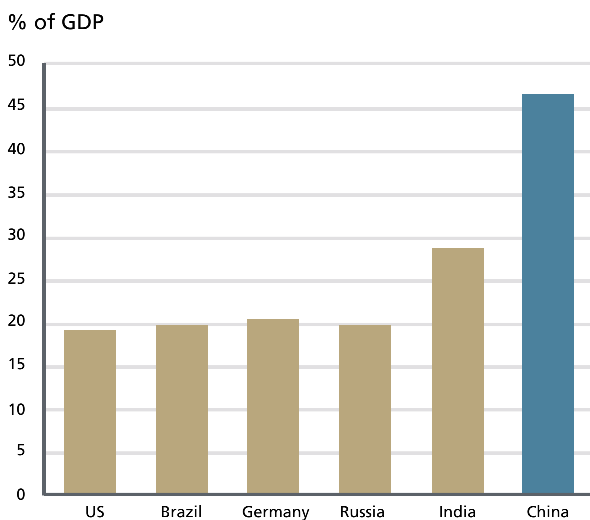
Against a backdrop of challenging economic conditions, the National People's Congress in March approved lowering the GDP target for this year and top leadership emphasised that 2016 will be a difficult year for growth. In an attempt to meet this year's 6.5%–7.0% growth target, policymakers put out more target numbers that will expand money and credit, just as they have in the past. The things China bears have complained about for years — infrastructure investment and local and central government deficits – will see continued support. Total social financing, the full calculation of money in China, will grow at its 2015 rate as well.

Continued turbulence in the stock market and yuan depreciation at the start of 2016 did little to disguise what could be a very difficult year ahead, putting the country's economic policies and reform agenda on top of the discussion list at this year's World Economic Forum meeting in Davos. Experts say that we will know that China has accomplished its gargantuan task of moving from an investment-based economy to a consumption-based economy when credit stops expanding at such an astounding rate.

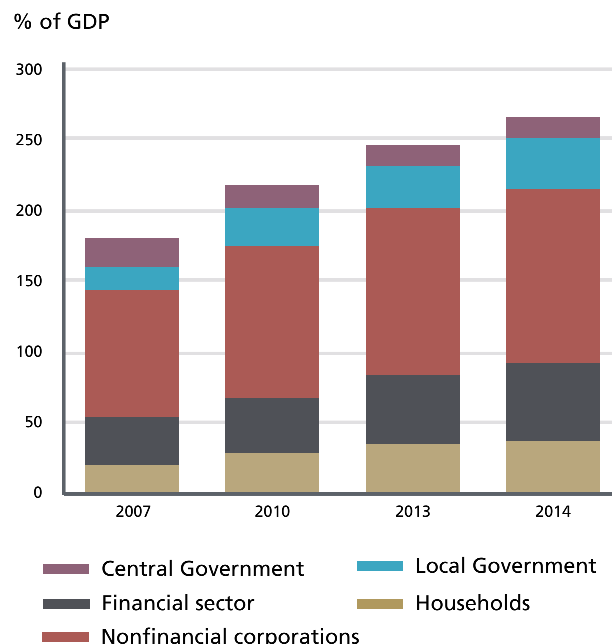
Helen Zhu, Head of China Equities at BlackRock was quoted in their quarterly publication as saying: "EM [emerging markets], FX [foreign exchange] and equities have been stuck in a vicious cycle of yuan depreciation fears begetting outflows and growth worries. Breaking this loop is key not only for EM, but for global stabilisation."

Chinese structural changes

Fixed investment 2014

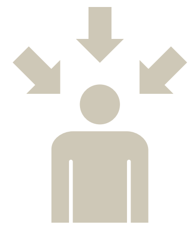


Chinese outstanding debt



Source: Oxford Economics

Theme spotlight



Other opportunities for commodities growth

The PSG Wealth investment division believes that the super commodity cycle previously fuelled by China is over, and will not be seen again. This does not mean that the demand for commodities in other markets, for example India or South America, will disappear. However the hunger for commodities in these markets will not be as quickly gobbled up as in China, and will most likely take place at a slower pace over the next 50 years. We also view China's economic transformation from a manufacturing-based economy to a consumption-based economy as more sustainable in the long run, albeit at a slower rate.

Our investment strategy has mainly been focused on developed markets. People often underestimate the resilience of these markets. We currently prefer investments in the developed world, especially when economic conditions at home are less favourable. In this regard we prefer to invest in multi-national conglomerates who use their own discretion to choose when and where to invest in emerging markets.

AUTUMN 2016 SURVEY: DIGITAL DISRUPTIONS

Technology is upsetting established workflows and processes in the financial services industry. Tasks once handled with paper money, a bulky computer, and human interaction are increasingly being completed entirely via digital interfaces. Given how pervasive financial services are across the globe, the disruption opportunity for fintech start-ups are massive. Start-ups, some of which have garnered blockbuster investments, are re-imagining almost every type of financial activity. Meanwhile, the old guard is trying to solve the puzzle the fintech revolution presents — how can incumbents benefit from the rise of digital, and how can they avoid obsolescence?

Take part in our new poll question by clicking here.

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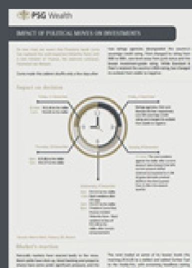
Published on a daily basis

Weekly



20 April
12 April
5 April
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16 March
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1 March
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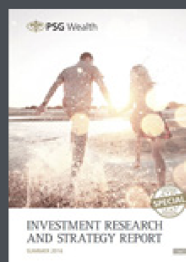

Summer 2015
Spring 2015

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