INVESTMENT RESEARCH AND STRATEGY REPORT

SPRING 2016

PSG Wealth

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Introduction

Macro-economic events are keeping markets volatile

Increased domestic sovereign risks, changing international politics, impeded interest rate normalisation, Brexit, and a flurry of corporate developments are all events that have had capital markets and investors on edge. The uncertainty that these events create in the minds of investors has been fuelling volatility in capital markets and could still impact markets in the months to come.

We reflect on some of these events that contributed to market instability over the last quarter in this edition. We also consider the performances of local and international markets, as well as our own investment solutions.

We discuss the results of our winter survey in the theme spotlight article. Please also take part in our spring 2016 survey on the upcoming S&P Global Ratings review.

Our message this year during volatile times has stayed the same. Stick to three core investment beliefs: manage expectations, adopt appropriate investment horizons and diversify. These beliefs are especially crucial to follow in the months ahead.

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
PSG Wealth 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

Macro-economic events are keeping markets volatile

Big numbers and potential sovereign changing events are all around us. These events may cause knee-jerk reactions among investors but they are pretty meaningless unless they are understood with some context.

Domestically, investor sentiment has been heavily influenced by political uncertainty in the past few months. The Public Protector Thuli Madonsela was prevented from releasing her report on state capture, by the High Court in Pretoria on the last day of her office in October. While uncertainty over fraud charges laid against Finance Minister Pravin Gordhan continued to contribute to nervousness in the local markets. Developments in the US presidential race have also caused market jitters that rippled through the globe, and the popular vote has not even taken place yet.

Increased domestic sovereign risks, changing international politics, impeded interest rate normalisation, Brexit, and a string of corporate developments are just some of the events that have had capital markets and investors on edge of late. The uncertainty that these events create in the minds of investors have been fuelling volatility in capital markets and could still impact markets in the months to come.

THE INCREASE IN POLITICAL RISK HAS RAISED THE PROBABILITY OF SOUTH AFRICA BEING DOWNGRADED

Earlier this year S&P Global Ratings agency warned that further political instability would be a risk to South Africa's sovereign credit rating. The market has priced in much of the bad news already, but the concern going forward is squarely focused on the impact of the cost of capital on the real economy, and the downstream effects of the downgrade on consumers and investors alike.

If a downgrade occurs, yields on bonds will have to move higher in order to compensate investors for the additional sovereign risks. This increases the governments' cost of capital which will place additional pressure on the national budget, and ultimately taxes. In addition, corporate financing cost will also increase, which places pressure on corporate earnings and economic growth. The move may attract a new investor segment, but this is little comfort in the greater context of things.

Although sovereign risk is just one element international ratings agencies consider when analysing a country's creditworthiness, South Africa was warned that political uncertainty would not bode well with rating agencies. If South Africa gets downgraded by S&P Global Ratings, it is highly likely that other rating agencies will follow suit. South Africa could avoid junk status if the political uncertainty is contained and concerns around our current account and fiscal budget are relieved. Here the country needs to improve its relative attractiveness in order to attract investment. We also need to increase or export-to-import ratio, and get a firmer grip on our fiscal spending. Hopefully clues towards these measures will be mentioned by the Minister of Finance in his medium-term budget speech at the end of October.

While one can understand market nervousness, there is also a flipside to this. The Finance Minister could come out of this in a strengthened state if the charges are successfully defended. Faith in South Africa's institutions (courts, treasury, SARS) could be boosted. And this would mean greater confidence, greater investment and a more vital economic outlook.

POLITICS CAN BE BRUTAL AS SEEN DOMESTICALLY AND EVEN IN THE US AND EU

Profound shifts are also taking place in the political sphere in the United States and the European Union. In America Clinton may mostly be viewed as the status quo candidate, but Donald Trump represents those who stand against globalisation and immigration. Some of the things the global marketplace has been built upon. However, predicting exact outcomes on the economic landscape for any election is a challenge, especially when it comes to the ability and inclination of each candidate to fulfil their campaign promises. No matter how committed a candidate might be to their respective manifestos, it will be up to US Congress to decide the end result of each proposal. Still the US president does have executive powers to push through certain measures, particularly in the international trade area, which could prove crucial to international markets.

Economic commentary

The potential shift in political and policy direction in the worlds' largest economy could be material, because it forms the tide for investor sentiment and future public policy. If Clinton wins, the consequences would be less far-reaching. However, if Trump takes the presidency, the US could see their focus shift from the promotion of Western secular ideals and democratic values towards a focus on security and business issues. This change in policy could impact America's closest trading partners the most, which could cause volatility in capital markets in the medium-term.

THE US FEDERAL RESERVE IS EXPECTING INTEREST RATES TO RISE AT A MORE SUBDUED PACE

While the Fed's decision will as always be data dependent, we expect year-on-year numbers to improve in the last quarter of the year. While unemployment has stayed below the target level of 6%, corporate earnings are still very low. Taking these various factors into account we don't expect the Fed to raise rates this year. It will take some time before sustainable data numbers convince the Fed to become less dovish.

MONETARY POLICY WILL HOWEVER REMAIN ON THE CENTRE STAGE PROVIDING DIRECTION TO CAPITAL MARKETS

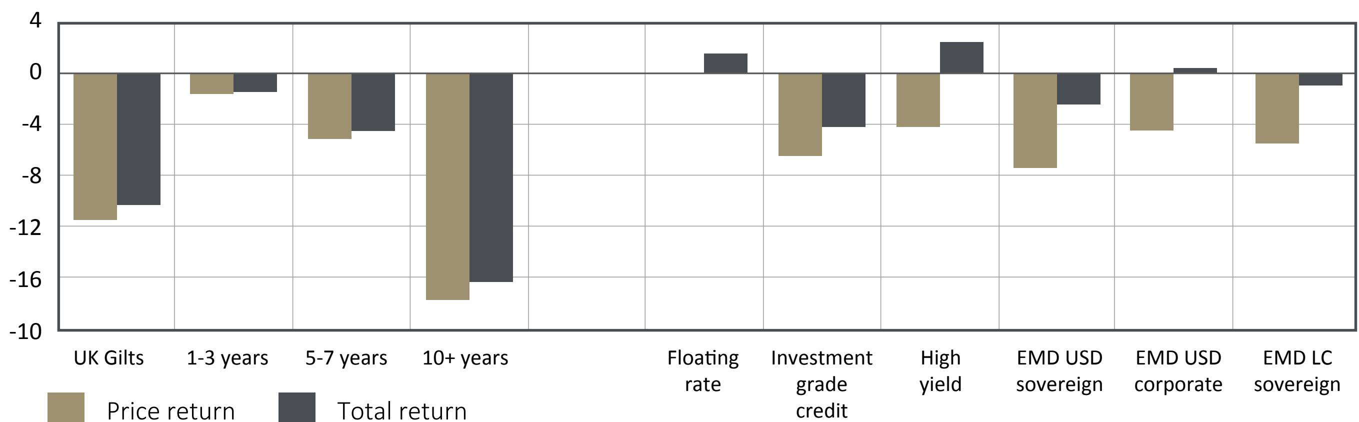
This is the case because yields will have to start normalising. Currently there is about US$13 trillion of (mostly government) bonds – roughly a third of all in issue – offering negative returns. The rest of this asset class is at record low yields, however, the risk/reward dynamic across much of the market is slanted very much towards the risk side of the equation. Indeed, the chart from JP Morgan below shows the impact of a 1% rise in interest rates on the returns of various parts of the bond market.

The data is based on prices as at 30 June and assumes constant credit spreads. For example, the owner of a ten-year Gilt would face a 17% capital loss in this scenario. This illustrates all too clearly why government bonds, while not necessarily an accident waiting to happen, have been described by some commentators as 'the reward-free risk'.

WE DO EXPECT SOME DOMESTIC INFLATION SURPRISES GOING FORWARD

We expect that the year-on-year inflation numbers will be lower in January/February 2017 as generally anticipated. While commodity prices and the strength of the rand could impact these numbers, we think the base effect has been greatly underestimated. Consumer prices in South Africa went up 5.9% year-on-year in August, following a 6% gain in the previous period. It is the lowest reading since December as transport prices went up at a slower pace. In February inflation stood at 7%. Expecting lower inflation for the first quarter of 2017 could prove to be a useful tailwind for markets.

Impact of 1% interest rate rise on bond market



Source: JPMorgan

Economic commentary

EVENTS AROUND RATING DOWNGRADES, THE US ELECTION AND BREXIT WILL CONTINUE TO CAUSE UNCERTAINTY IN MARKETS

We expect piecemeal progress to be made in the United Kingdom as policy makers continue to struggle with the practicalities around exiting the European Union (EU). The weak sterling has been a reflection of this uncertainty. During the last year the British pound has lost about 21% of its value against the US dollar, with the biggest drop in decades witnessed just after the Brexit vote. Shortly after this vote, various other European countries also indicated their hope to exit this 28-country bloc. Recently Bloomberg stated that France's 2017 presidential election is set to be like no other in the modern era.

"As supporters of the centre-right Republican party prepare to vote in their primary next month (November 2016), there are at least 12 declared candidates, with President Francois Hollande and his former Economy Minister Emmanuel Macron shaping up to join the fray. Though not all of the contenders will make it to April, the race is wide open with far-right leader Marine Le Pen making the running with her attacks on the European Union as voters' satisfaction with the bloc plummets."

Marine Le Pen has moderated the message since taking over the party founded by her father in 2011. She has avoided racist and xenophobic remarks while maintaining demands for France to exit the euro and reduce immigration. The result has been steadily rising popularity. Polls give Le Pen between 25% and 30% in the first round, making her the candidate to beat. The future of the European Union is potentially at stake if the French centre ground fails to hold out against Le Pen's advance. The most reassuring scenario for investors would see the moderate front-runner Alain Juppe, the mayor of Bordeaux, see off former French President Nicolas Sarkozy to claim the centre-right Republican nomination and then canter to a victory against Le Pen in May's runoff as voters converge on the mainstream candidate. Such a result would bolster the political partnership between France and Germany at the heart of the EU, as it embarks on negotiations over Britain's exit from the bloc. However, a Sarkozy victory in the primary would blow the race wide open.

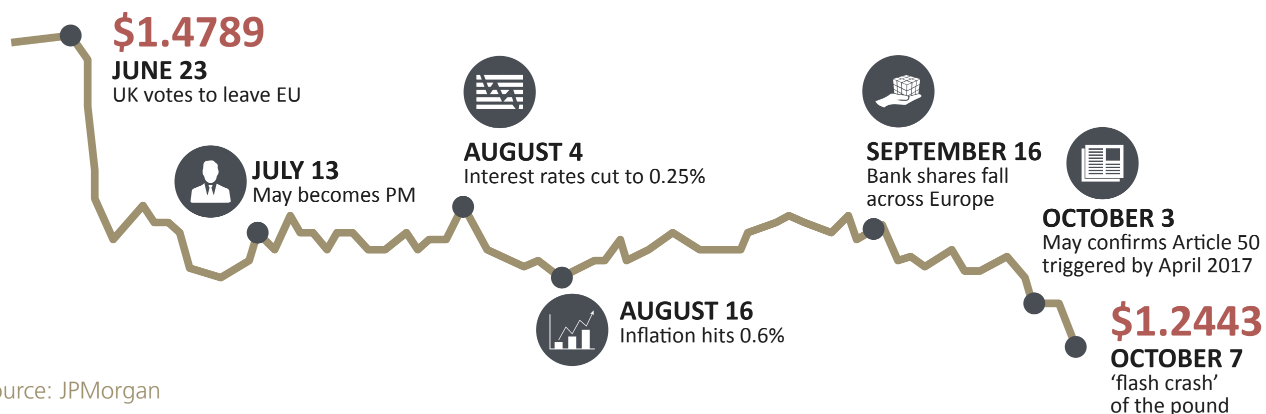
We feel the procrastinated policy implementation and slow progress towards an exit in the United Kingdom could likely put off other EU exits (from countries like France, the Netherlands, Austria, Finland and Hungary) in the medium term.

SO HOW SHOULD AN INVESTOR REACT TO ALL OF THESE EVENTS?

The main rule is not to panic. PSG Wealth is aware of the significant risks prevalent in local and global markets. For this reason we have always advocated diversification and our solutions offer a good balance between rand-hedge and interest-rate-sensitive investments.

Politics aside, data has shown an improved outlook for emerging markets and the South African economy – which advanced at an annualised 3.3% on quarter in the three months to June, recovering from a 1.2% contraction in the previous period. Before the recent political farce, equity valuations had also become a little less demanding. We are comfortable with our cautious positions but once the dust has settled some opportunities may well present themselves.

Struggle of the pound since Brexit



Source: JPMorgan

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Financial market review

Domestic equities experienced a flat quarter as a result of a sell-off in September

The FTSE/JSE All Share Index (ALSI) generated a 0.48% return for this quarter, following the 0.44% gain over the preceding quarter. The largest majority of the 6.59% return over a 12-month period has therefore been generated over the first half of this year.

THE RESOURCE SECTOR CONTINUED ITS REBOUND FROM DEPRESSED LEVELS

The 6.44% index gain over the preceding quarter was backed up with an even greater 8.07% return over the third quarter of 2016. This sector is currently the best performing sector over the preceding six months. That being said, the longer term returns for this sector remain bleak. Over the last three years investors lost 9.32% of their capital per annum.

THE LONG-TERM RETURNS FORM THE INDUSTRIALS SECTOR REMAIN ROBUST DESPITE THE SHORTER TERM WEAKNESSES

Industrial shares were generally the biggest losers over the preceding quarter, with the broad index shedding 2.05% over the quarter. However, the broader sector gained 22.31% per annum over the past five years. This signals that investors were willing to pay a premium for these defensive counters over the past five years, especially with annualised gains in excess of 22%. However, we remain of the opinion that some of these counters may now have reached a plateau. Further asset price inflation is too excessive, even after considering the relatively more defensive properties of the sector.

THE FINANCIAL SECTOR MARGINALLY RECOVERED SOME OF THE PRECEDING QUARTER'S LOSSES, WITH AN 85 BASIS POINT GAIN OVER THE PERIOD

Especially after this index shed 4.34% in the previous quarter. If one takes a long-term view, the ALSI generated an annualised return of 15.29% over the last five years, well-above our long-term expectation of inflation plus 7% for equities.

THE SOUTH AFRICAN ALL BOND INDEX (ALBI) CONTINUED WITH ITS STRONG RECOVERY

This follows the poor investment sentiment witnessed in December 2015. The six-month return for the ALBI now stands at 7.98%. This return was underpinned by a very strong third quarter which produced a 3.42% gain.

As indicated before, industrials, which gained 22.31% over the past five years, have been the main driver of returns. The resources sector was a significant detractor of returns over the past five years, recording a 9.32% annualised loss. Financials generated a 19.36% return over the same period. This is largely in line with the returns from the listed property sector, which totalled 17.86% over the last five years.

As we have been stating for some time now, it's worth noting that more than half of the earnings of JSE-listed companies are generated abroad, and often in developed markets. Although the macro-economic outlook for emerging markets looks unattractive at the moment, careful stock picking may yield very different results to what local macro-economic variables suggest.

PSG Wealth

Financial market review

Market indicators as at 30 September 2016

Index	Quarter end value	1M	3M	6M	1Y	3Y	5Y
ALSI	51 949.83	-0.93%	0.48%	0.92%	6.59%	8.84%	15.29%
Industrials	76 369.58	-3.51%	-2.05%	-1.55%	4.49%	12.10%	22.31%
Resources	18 357.65	4.48%	8.07%	15.03%	9.77%	-9.32%	-3.94%
Financials	40 419.21	1.39%	0.85%	-3.53%	-0.91%	13.16%	19.36%
Listed property	630.50	1.09%	-0.73%	-1.15%	3.76%	14.55%	17.86%
ALBI	531.61	2.98%	3.42%	7.98%	7.65%	6.82%	8.02%
ALBI 1-3 years	405.58	1.35%	2.21%	5.13%	7.98%	6.79%	6.76%
ALBI 3-7 years	503.37	2.12%	2.89%	6.82%	9.16%	7.20%	7.79%
ALBI 7-12 years	583.56	2.95%	3.17%	7.43%	7.92%	6.31%	8.17%
ALBI 12+ years	582.90	3.36%	3.98%	9.14%	7.19%	7.01%	8.48%
GOVI	529.53	2.89%	3.37%	7.76%	7.90%	6.75%	7.87%
OTHI	542.66	3.22%	3.50%	8.46%	6.90%	7.24%	8.88%
STeFI 3 Month	341.49	0.58%	1.78%	3.52%	6.79%	6.07%	5.74%
Volatility Index	13.29	-0.97%	-14.97%	-4.73%	-45.76%	-7.14%	-20.92%
S&P500	2 168.27	0.02%	3.85%	6.40%	15.43%	11.16%	16.37%
Euro Stoxx	3 002.24	-0.60%	5.08%	2.31%	-0.30%	4.03%	9.85%
Nikkei	16 449.84	-2.59%	5.61%	-1.84%	-5.40%	4.40%	13.59%
Hang Seng	23 284.87	1.34%	11.98%	12.07%	11.70%	0.62%	5.77%
Dax	970.75	-0.31%	8.76%	6.13%	9.60%	8.00%	14.78%
MSCI World	1 725.67	0.36%	4.38%	4.71%	9.09%	3.93%	11.26%
MSCI World ex US	1 702.98	0.95%	5.66%	3.36%	4.16%	-2.23%	4.28%
FTSE 100	6 899.33	1.74%	6.07%	11.73%	13.82%	2.25%	6.91%

Performance reported in base currency. Returns of periods exceeding one year have been annualised.

Sources: I-Net BFA, JPMorgan

PSG Wealth

Financial market review

PHENOMENAL RETURNS FOR INVESTORS WHO IMPLEMENTED THE ADVICE TO DIVERSIFY OFFSHORE

On the global front, the S&P 500 generated a 3.85% gain over the quarter, while its 12-month return stands at 15.43%. The five-year historic annualised return for the S&P500 is now at 16.37% in dollar terms. Investors have done well combined with the weakness in the rand over the period.

Another interesting observation on the return numbers of offshore indexes is that the Nikkei 225, and Hang Seng made strong recoveries (5.61% and 11.98% respectively). This follows the sharp declines in excess of 20% over the last year preceding to this quarter.

THE UNITED STATES HAS BEEN THE PRIMARY DRIVER OF GLOBAL STOCK MARKET RETURNS OVER THE MEDIUM TERM

This is illustrated by the large performance differentials seen between the MSCI World and MSCI World ex US indices. Over the short term however, we have seen a shift in this trend as emerging market indices recovered some losses.

As recoveries in larger economies start to take place, we expect the Purchasing Managers' Indices (PMIs) in emerging markets to signal improved growth. Perhaps the potential for higher spot prices on the back of increased demand could also be witnessed. There is however a risk that this theme may take some time to play out, given the current subdued outlook for global growth.

MSCI World versus MSCI World ex US indices

Index	1M	3M	6M	1Y	3Y	5Y
MSCI World	0.36%	4.38%	4.71%	9.09%	3.93%	11.26%
MSCI World ex US	0.95%	5.66%	3.36%	4.16%	-2.23%	4.28%
Difference	**-0.59%**	**-1.28%**	**1.35%**	**4.93%**	**6.16%**	**6.98%**

Sources: iNet BFA, JP. Morgan

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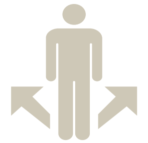
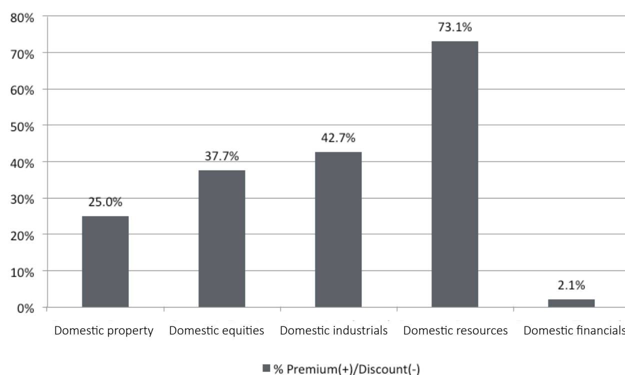
Tactical asset allocation preferences



Domestic equities are overvalued on an earnings basis

Domestic equities remain in excess of 30% overvalued relative to their historic yield according to our assessment. There are certainly some expensive pockets in the market and investors should expect continued volatility at current levels. That being said, skilled stock pickers should be able to find value in selected shares.

South African asset classes: Current earnings' yields versus long-term averages – premiums and discounts



Source: PSG Wealth research team

We remain of the opinion that the financial sector probably hosts the most opportunities from a valuation perspective. This sector is currently the only broad-based sector which trades close to its long-term average yield.

We are also aware that there may be hidden value on the local exchange – some counters are trading at very high price-to-earnings multiples, but the earnings are in a cyclical decline. Although the resource sector seems incredibly expensive from a yield perspective, we know that earnings have dropped in this cyclical part of the market. The mining sector is still consolidating their business operations, with smaller mines closing down and mining managers focusing on cleaning balance sheets. This usually places the sector in a position to make bigger profits, once spot prices recover and earnings start to flow through at greater operating margins.

We feel that although risks abound for the inexperienced investor, thorough research and careful stock picking could yield attractive returns. The key, in our opinion, is that the investment payoff should adequately reward investors for uncertainty. Secondly, only proceed in cases where there is more than sufficient margin of safety in the valuation, and lastly, monitor active positions very carefully.

We look at corporate balance sheets and debt structures that will be able to ride out the current storms as local economic strength is waning. 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. This in turn provides opportunities for players with healthy cash flows and strong balance sheets.

In light of the above, our positioning in 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

As always, we underpin these preferences with a focus on attractive valuations - ultimately bolstering expected alpha and managing downside risk more effectively.

DOMESTIC LISTED PROPERTY IS ROUGHLY OVERVALUED BY 25%

Our assessment of fair value shows that domestic listed property is now roughly 25% overvalued relative to its historic yield. In addition, we remain of the opinion that the interest rate cycle will impact the strength, affordability and sentiment within the domestic economy. This will present headwinds for capital growth in the property sector. We expect property yields, which are calculated as a percentage of the capital, to normalise on the back of downward pressure on capital values.

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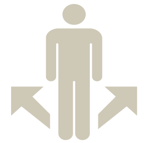
Tactical asset allocation preferences



HOWEVER THERE ARE 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:

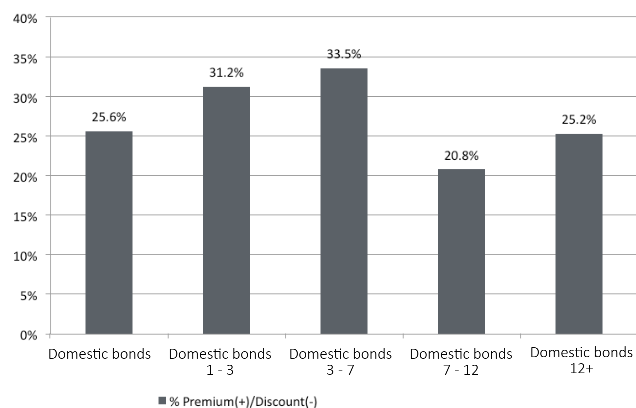
- low price-to-book values
- low levels of debt/gearing and strong credit ratings
- globally diversified portfolios, or counters that generate earnings abroad
- utilisation of structures that offer superior liquidity and diversification properties, like REITS
- superior distribution growth track records

DOMESTIC BONDS STILL REMAIN GENERALLY OVERVALUED

The aggregate yield of the All Bond Index still implies that this asset class remains generally overvalued. The implied premium is roughly 25%. Demand for bonds may dissipate in light of the increased risk of holding them with money market assets starting to offer some value. The relative risk-adjusted returns of bonds are also being compromised by higher interest rates on the horizon.

The seven to 12-year segment offers the lowest premium to historic yield, indicating this area of the yield curve probably has the least valuation risk at the moment.

South African asset classes: Current earnings yields vs long-term averages – premiums and discounts

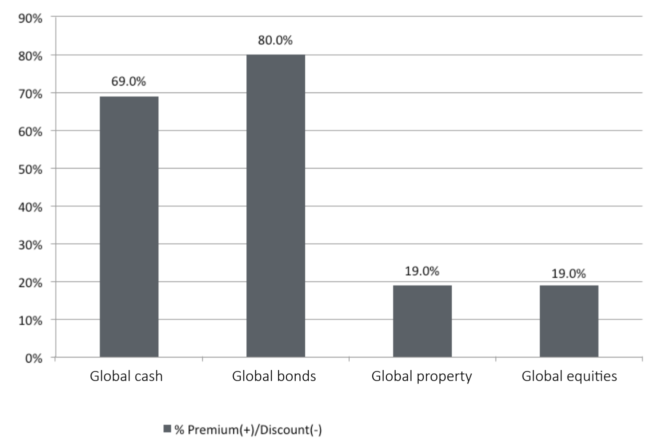


Source: PSG Wealth research team

The gross real yield on most short-dated money market assets was near zero until recently. On an after-cost, after-tax basis there was very little to be excited about. However, we believe this could change quite drastically in the medium term as further rate hikes are expected.

GLOBAL EQUITY VALUATIONS PRESENT A MIXED PICTURE

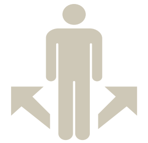
Global asset classes: Current earnings yields versus long-term averages – premiums and discounts



Source: PSG Wealth research team

The forward price-earnings (P/E) ratios of developed economies seem to indicate that developed market equities remain fairly valued to slightly overvalued. The forward P/E ratios for developing economies appear undervalued. Strong economic recoveries in developed countries like the United States and the United Kingdom should support further medium-term earnings growth.

Tactical asset allocation preferences

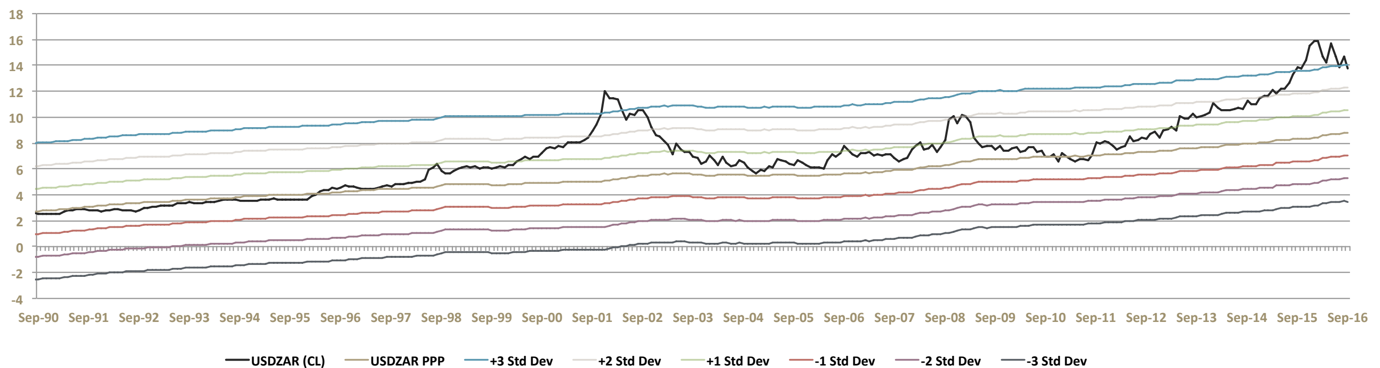


GLOBAL EQUITIES, ALTHOUGH TRADING AT A PREMIUM TO HISTORIC YIELD, REMAIN THE MOST ATTRACTIVE ASSET CLASS IN OUR MINDS

In many cases 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, which is now trading at a discount of greater than three standard deviations to purchasing power parity (PPP). Two key observations from this would be that:

1. The rand is trading well above the long-term PPP benchmark, which seems excessive even if a sovereign downgrade occurs. A downgrade would obviously result in additional short-term volatility but we are referring to long-term fundamentals.
2. Historically, the margin at which the rand is trading at now statistically reduces the possibility of further weakness quite significantly.

ZAR/USD exchange rate: Spot price versus PPP



Source: PSG Wealth research team

Although the weakness of the rand is a risk, there are many effective ways in which professional money managers can manage this risk effectively. We maintain the view that offshore equities remain attractive on a relative basis, and as indicated above have a preference for highly cash-generative businesses with strong balance sheets. Therefore, we are cautiously optimistic about defensive, developed market equity returns and remain overweight in this area of the market.

GLOBAL LISTED PROPERTY

From a valuation perspective, global listed property is still a more risk-efficient investment than global bonds. Global cash yields remain unattractive. Still, investors should be very cautious in this property sector 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 remain underweight in offshore fixed interest. 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 US Treasuries to normalise during the course of the next few years.

Valuations on global bonds remain severely stretched on the back of unchartered monetary policy stimulus and subsequent capital flows into 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 need to increase by roughly 3% to normalise. Although recent statements by the US Federal Reserve have 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.

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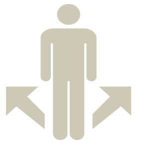
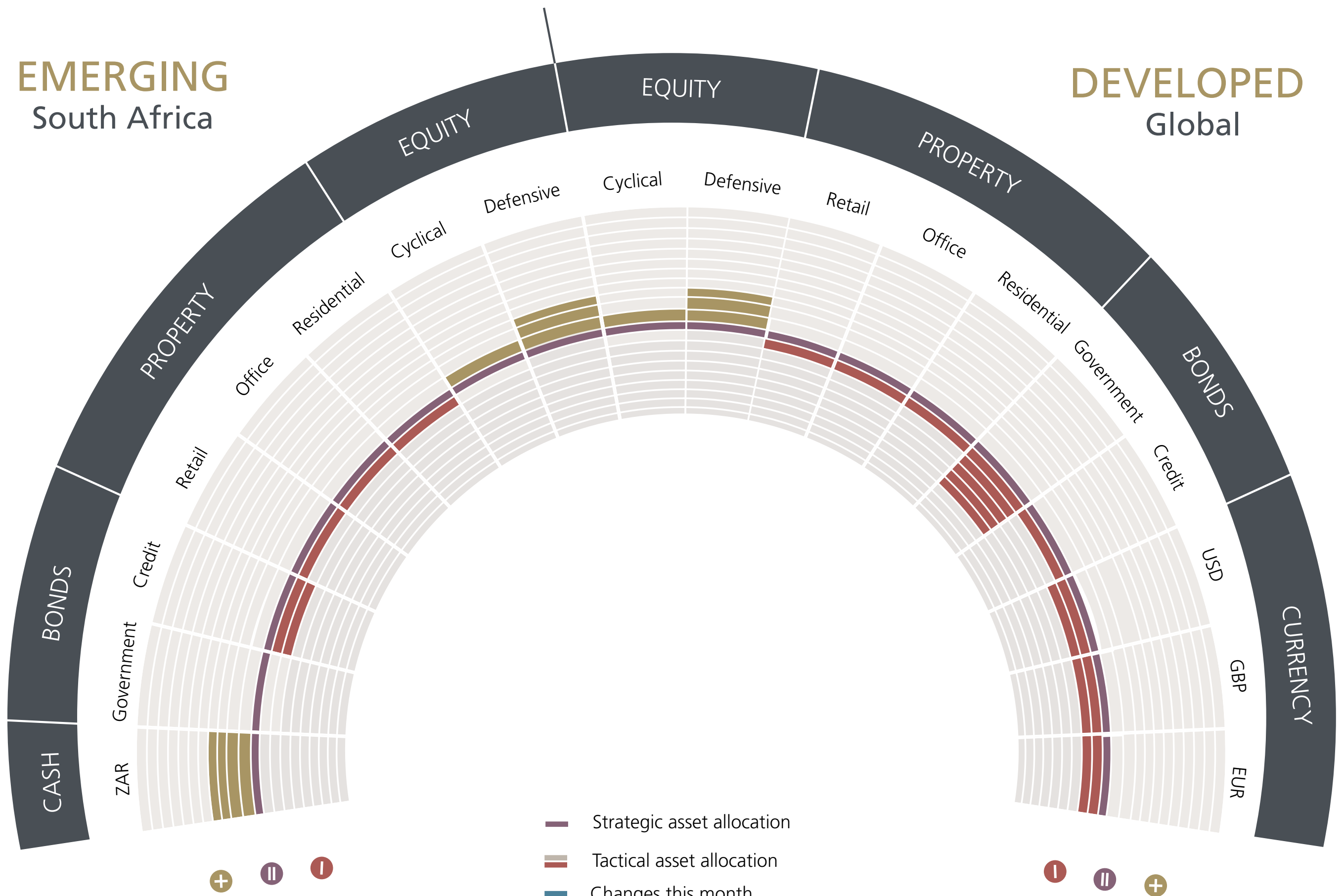
Tactical asset allocation preferences





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

Source: PSG Wealth research team

Domestic unit trust positioning

Equities: Should investors be concerned about short- and medium-term volatility and negative returns?

General equity portfolios recorded net annual outflows of R5.1 bn over a similar time period. This is according to collective investment schemes (CIS) statistics for the quarter and year ending June 2016 released by the Association for Savings and Investment South Africa (ASISA). A senior policy adviser at ASISA, Sunette Mulder, says that the majority of investors, and their advisers, have opted for a portfolio that offers similar returns to a general equity portfolio but with a more diversified risk profile.

The main reason why portfolios are diversified between different asset classes is to reduce the volatility of the portfolio over the short and medium term. Other objectives, like the ones mentioned below, are primarily short- and medium-term market timing tactics:

- to enhance the performance of equity portfolios by including higher yielding assets in times when equities are expected to perform poorly
- to protect equity investments against severe corrections or bear markets

INVESTING IS A LONG-TERM COMMITMENT

Equities have proved time and time again that as an asset class they deliver the highest returns over the long term. So if investors truly believe the principle that equity investments are long-term commitments, should they be concerned about short- and medium-term volatility or corrections?

LONG-TERM RETURNS FROM EQUITIES

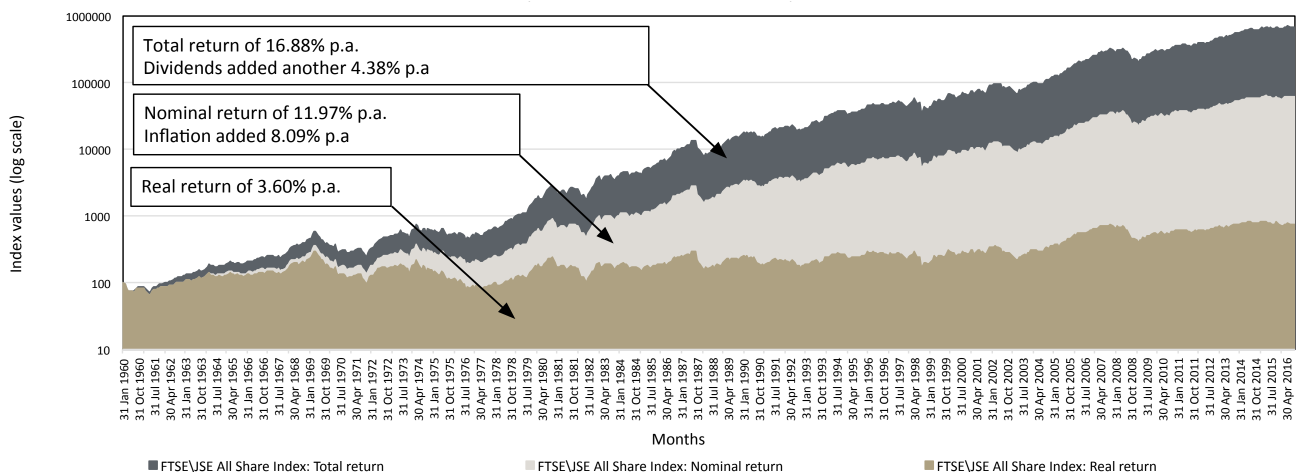
An analysis of the long-term returns of equities (from 31 January 1960 to 30 September 2016) has revealed that the FTSE/JSE All Share Index (ALSI) recorded a nominal return (not adjusted for inflation) of 11.97% per annum.

If the index is adjusted for inflation over this 56-year period then real returns drop to 3.60% per annum. This correlates to the long-term real economic growth of South Africa. The 8.09% difference between the nominal return and the real return is our long-term inflation rate.

INVESTORS ARE ALSO ENTITLED TO THE DIVIDENDS COMPANIES PAY OUT WHEN INVESTING IN EQUITIES

If they reinvested these dividends back into equities, the long-term total return of the index jumps to 16.88% - an additional return of 4.38%. Equities are able to deliver a nominal return of inflation plus 3.60% over the long term, without the reinvestment of dividends. When the dividends are reinvested, equities could offer a total return of inflation plus 8.14% over the long term.

FTSE/JSE All Share Index total return: Components of return



Source: PSG Wealth research team, I-Net BFA

PSG Wealth

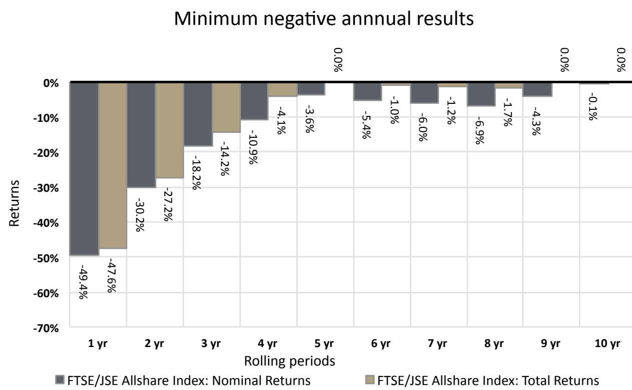
Domestic unit trust positioning

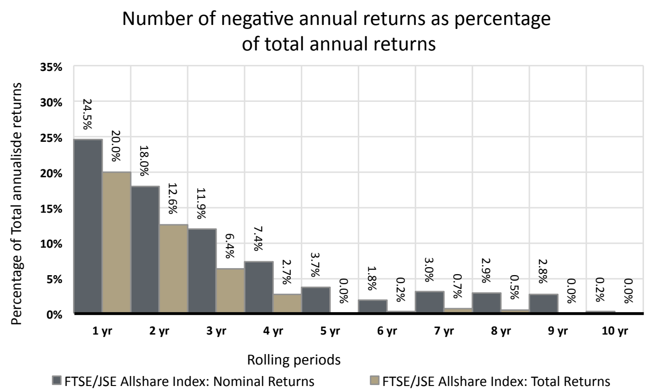
FREQUENCY AND MAGNITUDE OF NEGATIVE RETURNS FROM EQUITIES

The risk of an investment in equities is generally associated with higher volatility present in markets. Volatility, however, is influenced by both the upside, and the downside movement in values. One needs to consider the potential of negative returns to assess the real risks inherent in an investment in equities.

To consider negative returns our analyst used calculated rolling returns for the ALSI and the FTSE/JSE All Share Total Return Index over all periods from one to 20 years. The minimum annualised return (most negative return) and the number of negative returns for each rolling period was extracted and is summarised in the two graphs below.

Analysis of negative returns





Source: PSG Wealth research team, I-Net BFA

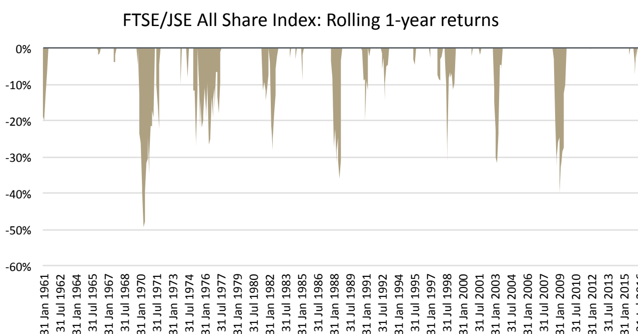
The graph shows that the worst performance of a negative 49.4% return was achieved by the ALSI over the one-year rolling period, while 24.5% of the returns were negative. The worst performance for the two-year rolling period dropped to negative 30.2%, while 18% of these returns were negative. When the investment period is increased to five years or longer, the magnitude and frequency of negative returns dropped to very low levels.

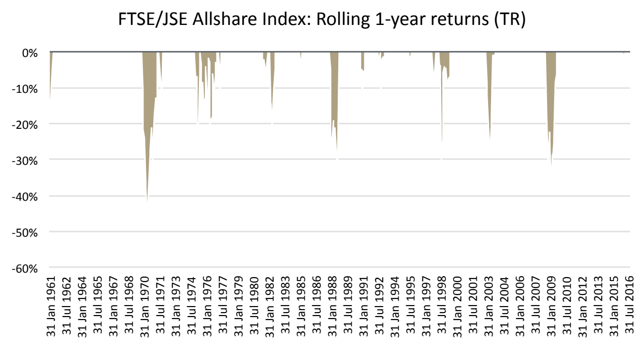
The worst performance of the FTSE/JSE All Share Total Return Index was a negative 47.6% over the one-year rolling period, while 20% of the returns were negative. The worst performance for the two-year rolling period dropped to negative 27.2%, while only 12% of these returns were negative. The magnitude and frequency of negative returns dropped noticeably more for the total return index – a drop of close to zero when investing for five years and longer.

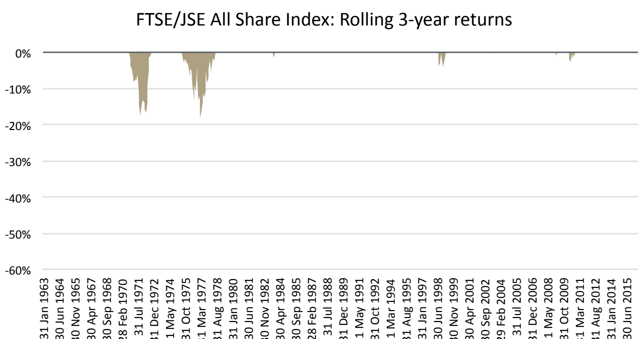
Domestic unit trust positioning

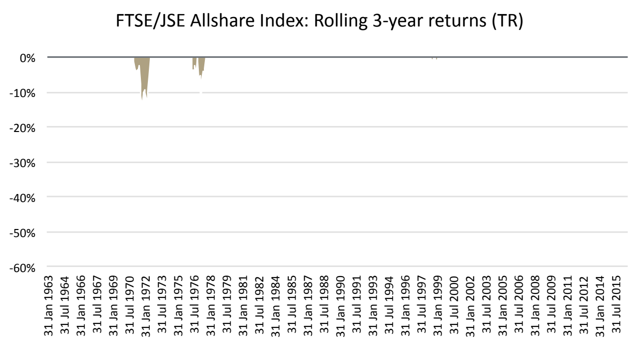
The series of graphs below are even more indicative of how insignificant the frequency and magnitude of negative returns from equities are when the investment period increases from one year to three years, and from three years to five years.

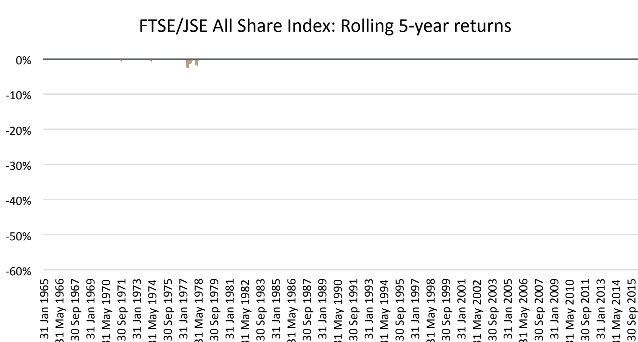
Nominal and total return drawdowns

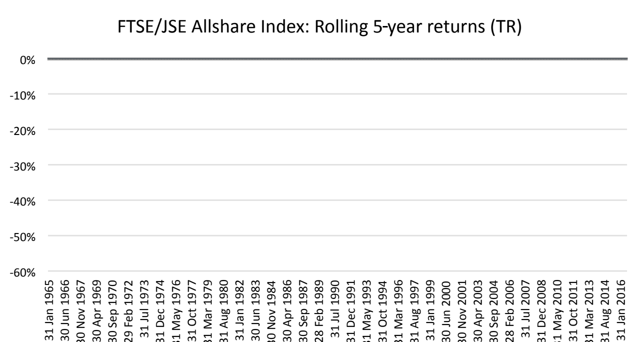












Source: PSG Wealth research team, I-Net BFA

EQUITIES HAVE THE HIGHEST POTENTIAL TO CREATE WEALTH

The asset class with the highest potential to create wealth remains equity. It is, however, a risky investment with the potential for large losses in capital over the short term. These risks are easily reduced, and eventually negated, if the investment horizon increases to more than five years. It will be interesting to see if the trend in outflows from equity funds continue over time. Or if it will return to positive when company earnings pick up and the current high valuations return to more attractive levels.

PSG Wealth

Offshore mutual fund positioning

Removing emotion from investments: factual evidence for global diversification

MOST INVESTORS ARE CURRENTLY KEPT AWAKE AT NIGHT DUE TO THE HIGH LEVEL OF UNCERTAINTY REGARDING THE FUTURE OF SOUTH AFRICA

This makes sense given the volatile sovereign environment, weak economic indicators and the prevailing negative consumer and business sentiment. Given these concerns many investors feel the need to move their money offshore. However all of these factors are based largely on emotion and one of the key requirements to be a successful investor is to remove emotions from your investment decision-making framework.

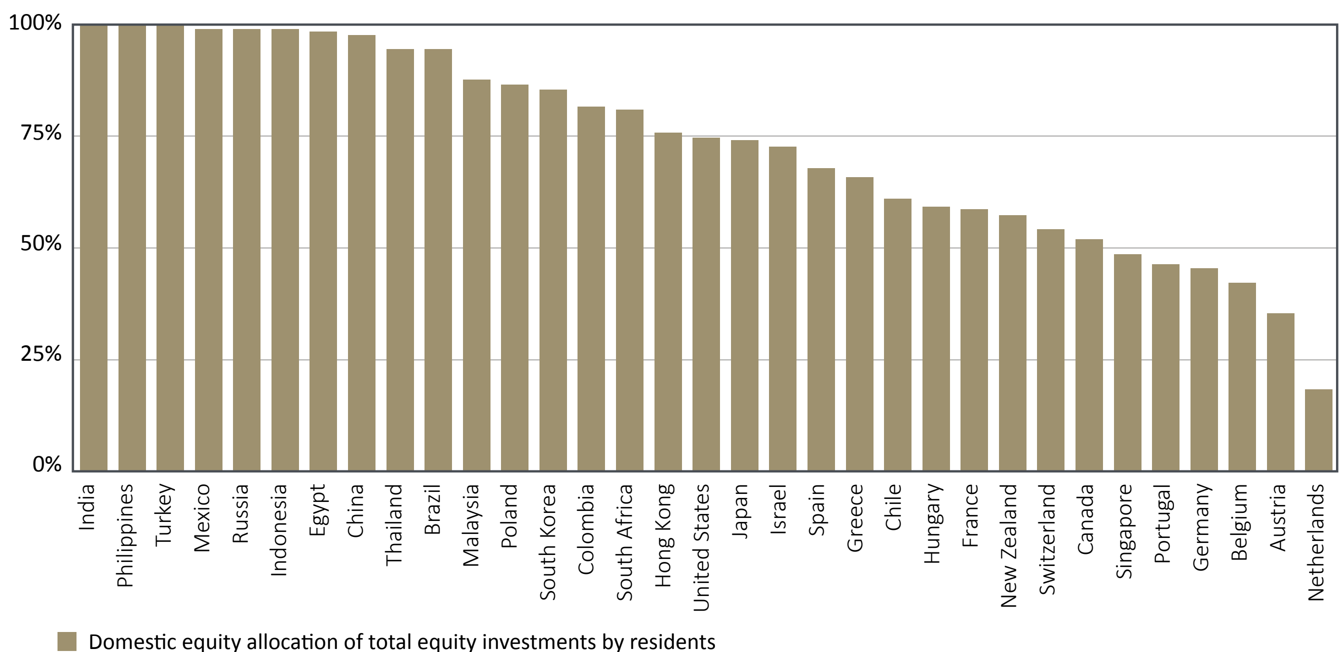
PSG WEALTH PREFERS TO KEEP EMOTIONS OUT OF THE EQUATION AND FOCUS ON FACTS

For this reason, at a recent discussion and feedback sessions held with advisers and clients, the message from the PSG Wealth research team has been that when investing offshore, clients should be doing it not because of a specific view of the rand (views that are often caused by sentiment driven by political turmoil), but rather for the diversification benefits it offers. Over the past two decades consensus views on the rand have often been wrong, often spectacularly so. In this article the PSG Wealth research team sheds more light on the concept of 'diversification', with a special focus on why investors should diversify their portfolios globally.

A DISCUSSION ON THE STOCKMARKET USUALLY REFERS TO AN INDEX WHICH ONLY TRACKS SHARES IN THE INVESTORS' HOME COUNTRY

Domestically 'the market' is mostly represented by the FTSE/JSE All Share Index (ALSI). Charles Schwab, a US-based brokerage and banking company, recently noted that this 'home bias' is evident when it comes to the make-up of investors' stock portfolios across the globe. Investors tend to hold mostly domestic stocks - even when their country is the home of only a small portion of the world's stockmarket. This is shown in the graph below.

Home bias: Investors' portfolio overweight their home country no matter where they live



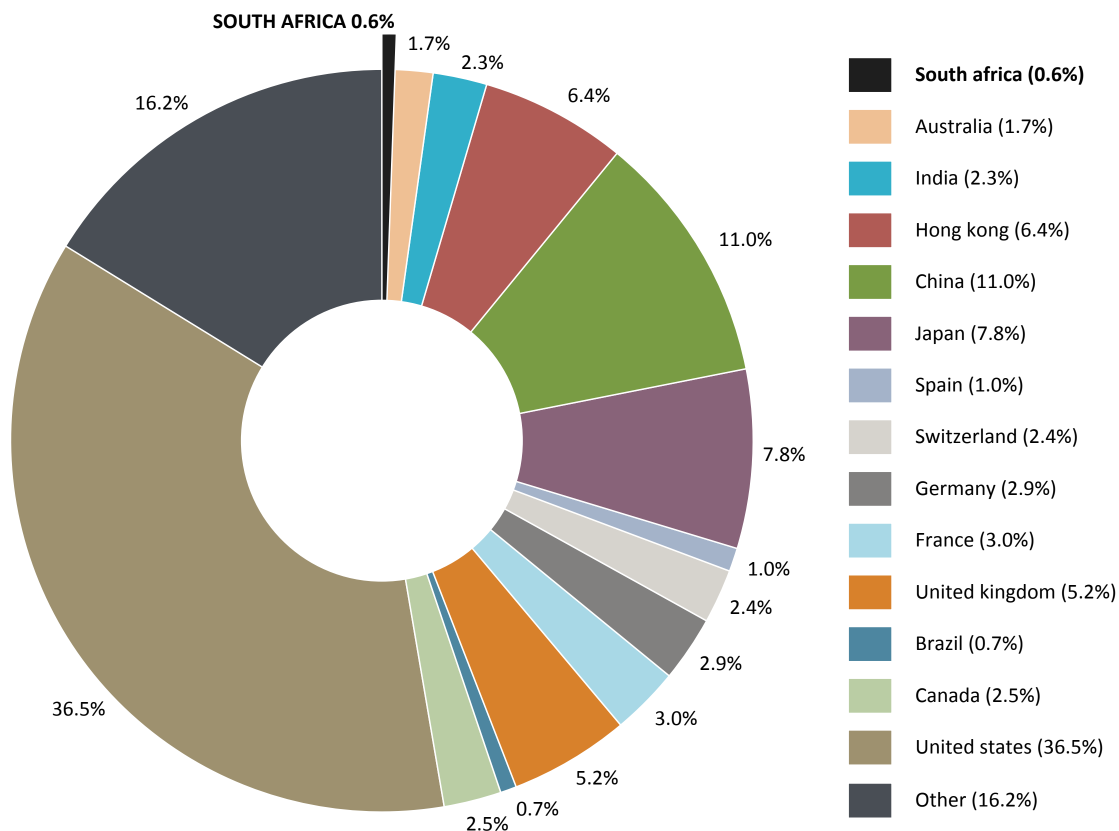
Source: Charles Schwab, International Monetary Fund Coordinated Portfolio Investment Survey, FactSet, Data as at 11 Augustus 2016

PSG Wealth

Offshore mutual fund positioning

Similarly, South African investors seem to believe that they are sufficiently diversified when about 75% to 80% of their equity investments are held inside South Africa. However, the Johannesburg Stock Exchange (JSE) merely represents about 0.6% of the global equity market (see the pie chart below).

Relative sizes of world stock markets at the end of 2015



Source: Coronation, Bloomberg

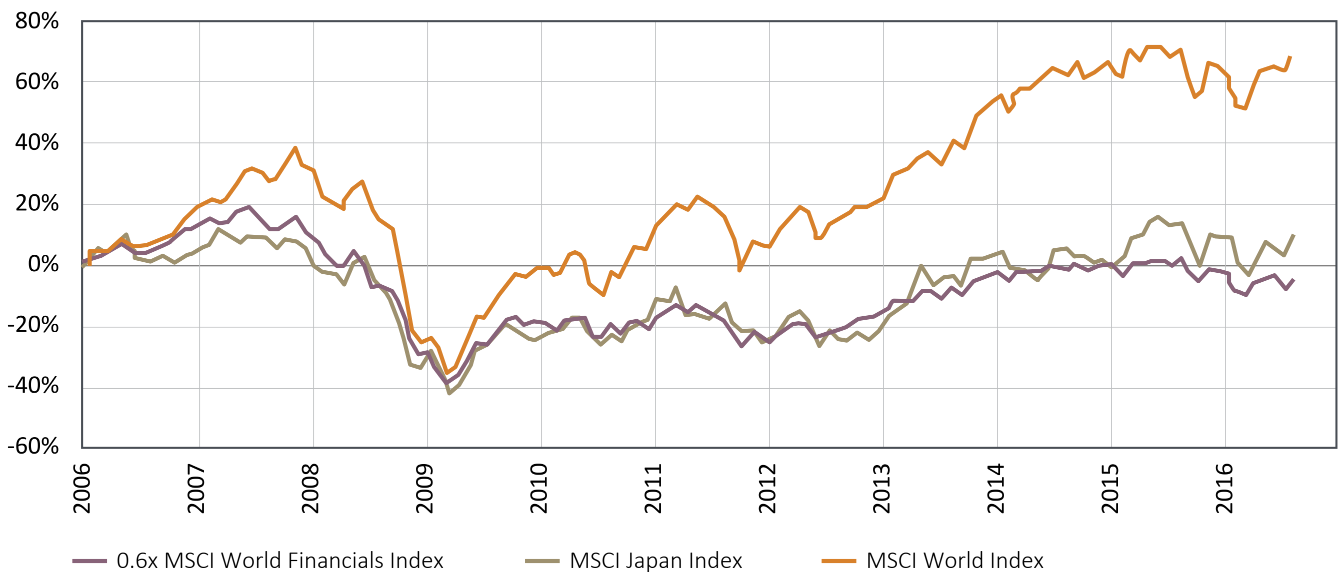
Investors forego the opportunity to gain access to growth regions that benefit from mega-drivers like industrialisation, urbanisation and growing consumerism when only investing in domestic markets. Additionally, diversifying offshore gives local investors access to industries that are not present in the South African market (e.g. information technology, electronics, pharmaceuticals). Investing offshore also provides a wider opportunity within industries because there are so many quality firms from which to choose.

SELECTING SHARES IN MAJOR COUNTRIES DOES NOT PROVIDE SUFFICIENT DIVERSIFICATION

An analysis of country level stock returns against the returns of global equity sectors indicates that no single country provides their local investors with full exposure in the global stockmarket. In fact, most investors would be surprised to know how closely stock markets even in major countries track the performance of a single sector in the global stockmarket. For example, in Japan the stockmarket closely tracks the global financial sector (see graph on next page). Investment strategist at the Schwab Centre for Financial Research in the United States, Jeffrey Kleintop, notes that this sectoral dependence illustrates the lack of diversification inherent in having a portfolio with a large home bias. Even for those investors who live in a major country.

Offshore mutual fund positioning

Japan's stock market behaves like the global financial sector



Source: Charles Schwab, MSCI data as at 11 August 2016

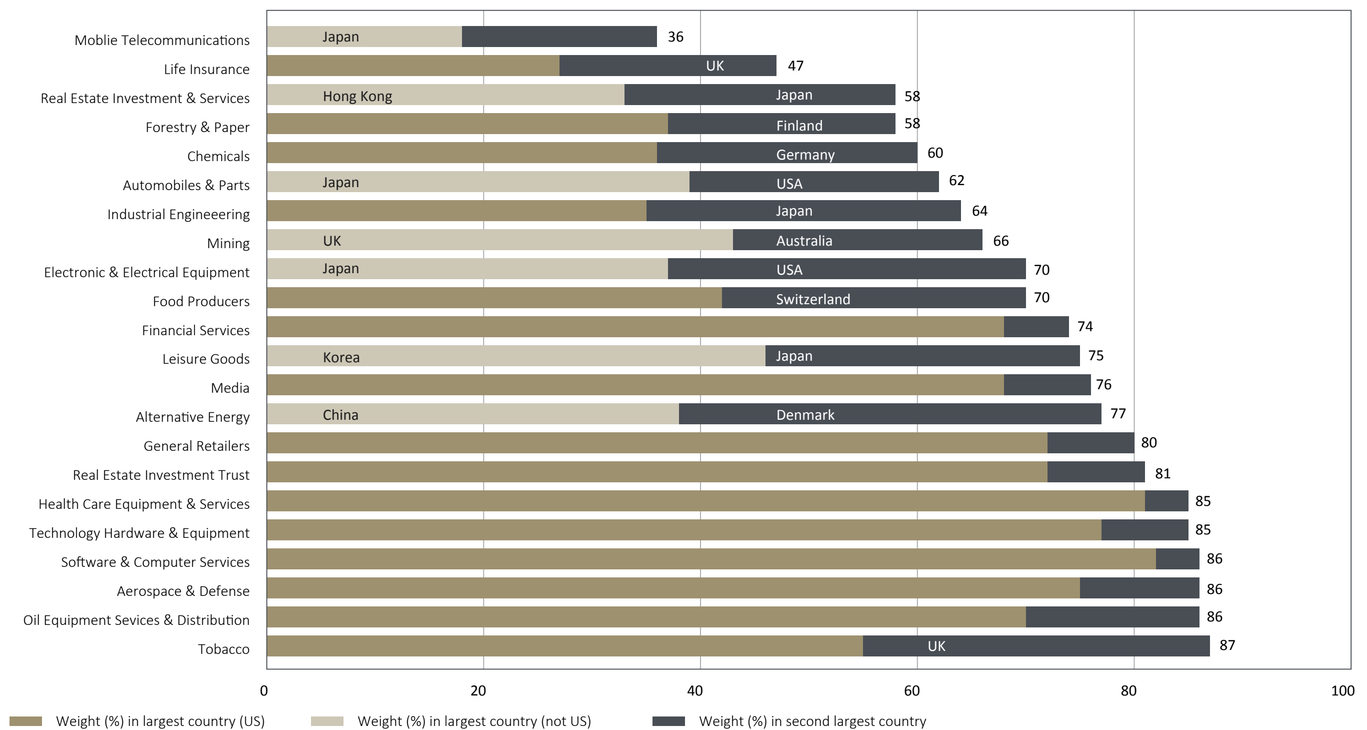
The graph above illustrates how similar the performance of the Japanese stockmarket is to that of the MSCI World Financial Index. One only needs to multiply this global financial index by 0.6 to get almost the exact performance results of the Japanese market over this period. Interestingly the financial sector is not the largest in Japan's stock market. The consumer discretionary sector is the largest, which includes globally-recognised companies like Toyota and Sony. However, the influence of global financial conditions on a variety of Japanese companies is evident in their performance. Rather than being broadly diversified, the home bias of a Japanese investor means that they have about 75% of their portfolios linked to the moves in the global financial sector.

Other interesting single sector countries include Canada whose stockmarket behaves very similarly to 1.3 times that of the MSCI World Energy Index. This is even though only about 22% of their market is made up of energy stocks. Remarkably even the Canadian banking sector is tied closely to the commodity cycle due to their economy's reliance on natural resources. The stockmarket in the United States closely tracks the MSCI World Information Technology Index when multiplied by 0.9.

Offshore mutual fund positioning

The graph below shows the concentration of industry by country. This illustrates that investors don't benefit from diversification when they restrict their investments to their own country. Even combining South African exposure with a selection of some of the major countries will likely not result in a fully diversified portfolio. Broader global diversification is required to gain access to full global market exposure.

Concentration of industries by country



Source: Coronation, FTSE International world index series, Credit Suisse Global Investment Returns Yearbook 2015

STOCKS ARE NOT SHARES IN A COUNTRY

Geographic location is increasingly less meaningful when it comes to investing. At one stage, all markets were largely domestic and the fortunes of companies largely depended on their local environment. But international trade now accounts for nearly two thirds of the world's gross domestic product (GDP). According to the World Bank this is up from less than half that just 10 years ago and one third about 30 years ago. The world has increasingly become one global marketplace for companies to sell their products and operate within.

When buying the stock of a company based in a certain country, it's important to realise that it is not like owning a share in that country. The sector that a stock belongs to, such as financials or technology, matters more to performance than the company's home country or region. A thorough analysis of the performance of various country and global equity sectors highlights that sector exposure plays a big part in understanding the difference in performance from country to country – regardless of politics or economics. It is interesting to note that stocks tend to correlate more closely with peers in the same global sector than they do with domestic stocks in other domestic sectors. In other words, the global sector a stock is located in has a bigger impact on its performance, than the geographic region the company is based in. When looking at long-term historical numbers this was not always the case. It has only become a reality in the past decade, largely due to the increase in globalisation.

Offshore mutual fund positioning

Correlation of MSCI Europe Sector Indexes to MSCI World Sector Indexes and MSCI Europe Index

	Europe Sector and World Sector	Europe Sector and Europe
Consumer staples	0.99	0.85
Materials	0.99	0.92
Health care	0.98	0.85
Energy	0.98	0.94
Consumer discretionary	0.97	0.93
Industrials	0.97	0.98
Utilities	0.96	0.89
Telecom	0.94	0.90
Financials	0.96	0.64
Information technology	0.69	0.23

Correlation measured using monthly data from July 2000 to December 2014. All indices calculated using total return in US dollars.

Source: Charles Schwab, Bloomberg

Correlation measures the degree and type of relationship between two things. Statistically, the degree to which they move similarly over a period of time can range from -1.0, when they always move in opposite directions, to +1.0, when they always move in the same direction. Zero shows no consistent relationship between them.

The table above shows that almost every one of the ten sectors of the stockmarket in Europe has a higher correlation with the same global sector, than with stocks in Europe. For example, the total return in dollars of the MSCI Europe Financials Index since its inception in July 2000 has a 0.96 correlation with the MSCI World Financials Index, but only a 0.64 correlation with the MSCI Europe Index. The dominance of a stock's sector over geography, when it comes to performance, is even more consistent when looking at returns in local currencies. The same analysis in the United States finds that eight out of ten United States' sectors have a significantly higher correlation with the global sector, than with the local general market index. These relationships were even evident during the volatile market conditions experienced over the past 14 years.

Take note that this analysis does not suggest that the base country of a company does not matter. It definitely has an impact on performance, especially for some emerging markets where regional and country-specific factors seem to have more of an influence on markets than on their developed market peers. When investing, a global perspective on the developments in sectors across countries, is essential to understand the drivers of performance. For this reason we prefer to use managers with a global mandate that have the necessary skills and expertise to understand the drivers of performance, without any bias towards a specific geographical location.

MATCH YOUR LIABILITIES

An argument used against significant offshore allocation is that South African investors should attempt to match their investment returns with local inflation – thus matching their liabilities. However, the fund management firm Coronation has noted that it is worthwhile to remember that many items in a consumer's shopping basket (from fuel and food to healthcare) are largely priced in foreign currencies. Especially because the inputs are either commodities (with prices struck in global markets) or heavily reliant on imported products. Viewed from this perspective, having adequate offshore exposure is merely a hedge against the long-term change in the price of this part of your future shopping basket. Episodes of currency weakness will more than likely remain a strong driver of price increases in the future.

OPTIMISATION AND ACHIEVING INVESTMENT OBJECTIVES

Benefits of suitable diversification includes the reduction in overall portfolio volatility and drawdown risks required to achieve specific investment objectives. According to studies quoted by Coronation, optimal diversification is present in portfolios with a minimum offshore allocation of 20% to 30%. Investors should aim for this amount of offshore allocation throughout the cycle of long-term investments. Especially if investors require a return of inflation plus 4% to 5% in rand terms. When investors have a more diverse spending need, which includes a larger portion of foreign currency denominated spending, this could justify a larger offshore allocation.

PSG Wealth

Offshore mutual fund positioning

INVESTING OFFSHORE SHOULD BE DONE FOR THE RIGHT REASONS

Diversification is the best reason and not because domestic political or economic conditions weaken the rand. To be well diversified, an investor should have exposure to many different sectors of the stockmarket. Broad global exposure is needed to achieve this. Even a portfolio that holds only some of the major countries may behave as if it only has exposure to a few sectors in the global stockmarket, rather than being fully diversified across all ten.

Diversification can help lower portfolio volatility and ensure you always have some exposure to whatever sector is performing the best. Understandably, diversification can also seem to be a drag on portfolio performance when one sector sharply outperforms the others for an extended period. How much exposure outside your home country should you have in your portfolio? That depends on your risk tolerance and time horizon. It is clear from the data that most investors can broaden their opportunity set and diversify their portfolios, simply by significantly boosting the international portion of their portfolios.

GLOBAL FUNDS – PERFORMANCE AND POSITIONING

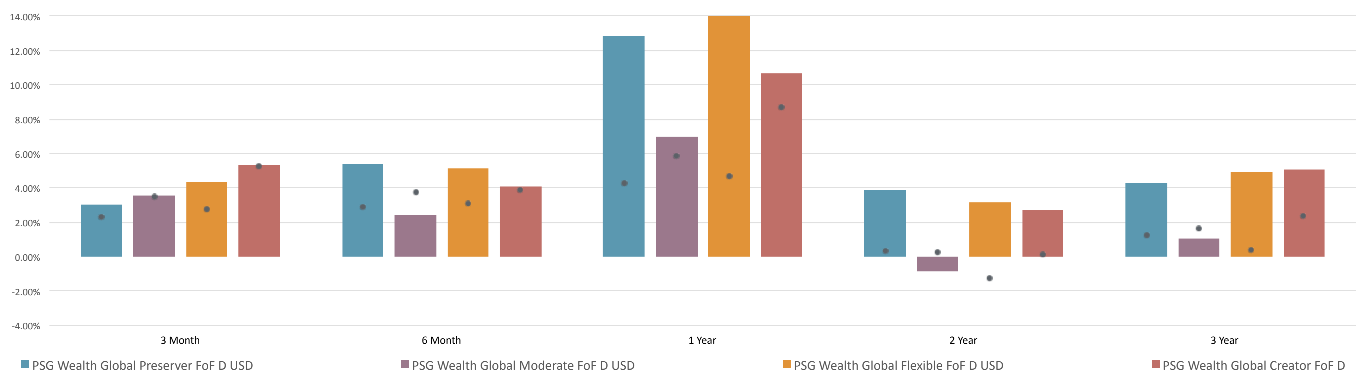
The PSG Wealth Global Preserver Fund of Funds (USD) had an exceptional 12 months ending September 2016, outperforming the GIFS USD cautious sector average by 8.5% in USD. For the third quarter of 2016, the portfolio outperformed the sector by 0.7%. The PSG Wealth Global Preserver Fund of Funds (GBP) also delivered top quartile returns over the last 12 months and for the third quarter of 2016. During the quarter the allocation to equity funds was reduced by 10% in both portfolios, to reduce the volatility of returns and limit potential downside in the case of a correction in equity markets.

The PSG Wealth Global Moderate Fund of Funds outperformed the sector average over the last 12 months by 1.10% in USD and also ended the third quarter slightly ahead of the sector average. During the quarter three new funds were added to the portfolio, namely the MFS Meridian Global Total Return, Schroder Global Multi Asset Flexible and the T. Rowe Price Global Balanced Fund.

The PSG Wealth Global Flexible Fund of Funds (USD) delivered exceptional returns for the 12 months ending September 2016, delivering excess returns of 9.5% in USD over the GIFS USD flexible allocation sector average. For the third quarter of 2016, the fund outperformed the sector by 1.6%. The PSG Wealth Global Flexible Fund of Funds (GBP) also delivered top quartile returns over the last 12 months and for the third quarter of 2016.

The PSG Wealth Global Creator Fund of Funds had a strong 12 months ending September 2016, outperforming the global sector average by 1.9% in USD. For the third quarter of 2016, the portfolio was slightly ahead of the sector average and also outperformed the MSCI World Index.

Performance of offshore solutions in USD



Dots represents the return of relevant sector average. Only D-class funds represented in this graph.

Source: PSG Wealth research team, Morningstar

Offshore mutual fund positioning

Look-through positioning of the PSG Wealth global fund range

PSG Wealth global fund range Asset and sector allocation as at 30 September 2016						
	PSG Wealth Global Preserver FoF (USD)	PSG Wealth Global Preserver FoF (GBP)	PSG Wealth Global Moderate FoF	PSG Wealth Global Flexible FoF (USD)	PSG Wealth Global Flexible FoF (GBP)	PSG Wealth Global Creator FoF
Foreign equities	**44.2**	**44.1**	**55.4**	**85.5**	**86.1**	**95.3**
Basic materials	1.3	1.3	2.2	1.6	0.4	2.1
Communication services	2.3	2.3	2.4	3.7	4.8	3.0
Consumer cyclical	4.5	4.5	6.2	10.1	16.9	11.4
Consumer defensive	3.5	3.5	5.3	15.2	8.8	14.5
Healthcare	5.4	5.4	7.3	13.0	14.0	15.5
Industrials	4.5	4.4	6.1	9.9	10.7	10.5
Technology	4.6	4.6	7.1	17.2	13.2	18.5
Energy	3.7	3.7	4.2	3.6	3.4	3.7
Financial services	5.1	5.0	13.3	12.4	14.2	15.4
Utilities	13.6	13.5	1.3	0.6	1.5	0.8
Other/Undisclosed	-4.2	-4.2	-	-1.7	-1.7	-
Foreign property	**11.7**	**11.5**	**1.1**	**4.9**	**5.4**	**-**
Foreign bonds	**16.2**	**16.3**	**29.0**	**1.9**	**1.9**	**-**
Foreign other	**14.0**	**14.2**	**5.4**	**0.1**	**0.0**	**0.0**
Foreign cash	**14.0**	**13.9**	**8.7**	**7.7**	**6.6**	**4.7**
Domestic assets	**0.0**	**0.0**	**0.4**	**-**	**0.1**	**-**
PORTFOLIO TOTAL	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: PSG Wealth research team

As noted in the performance feedback, general equity managers were removed from the PSG Wealth Global Preserver Fund of Funds (USD and GBP) during the quarter to reduce portfolio volatility and risk of drawdowns. This change resulted in a decrease in equity allocation of about 9% in both the USD and GBP versions.

The effect of the new portfolios used in the PSG Wealth Global Moderate Fund of Funds was a decrease in the equity allocation of 10.5% and an increase in the fixed interest allocation of 14.5% from last quarter. Two of the replaced managers did not use fixed interest in their portfolios as they had flexible mandates focused on equities and cash. The new managers have a global allocation mandate and therefore use their expertise to identify good opportunities in the fixed interest market. The allocation to the financial services sector decreased by 8.7%, while the largest sector increase was in the healthcare sector where the allocation increased by 1.1%.

Within the PSG Wealth Global Creator Fund of Funds the overall equity allocation increased by 0.4% with cash decreasing with the same amount. The allocation to the consumer defensive and communication services sectors in the last quarter increased by 1.5% and 1.4% respectively. The industrial sector decreased by 1.8% and the technology sector decreased by 1.4%.

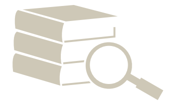
Offshore mutual fund positioning

PSG Wealth global fund range Regional allocation as at 30 September 2016	PSG Wealth Global Preserver FoF (USD)	PSG Wealth Global Preserver FoF (GBP)	PSG Wealth Global Moderate FoF	PSG Wealth Global Flexible FoF (USD)	PSG Wealth Global Flexible FoF (GBP)	PSG Wealth Global Creator FoF
Americas	**50.8**	**50.3**	**56.0**	**62.3**	**63.0**	**63.4**
North America	49.2	48.8	54.3	61.9	62.2	62.8
Latin America	1.6	1.5	1.7	0.4	0.8	0.6
Greater Europe	**26.5**	**28.9**	**26.1**	**28.7**	**29.3**	**28.7**
United Kingdom	10.0	11.1	12.2	14.0	13.0	12.1
Europe developed	13.5	15.3	12.5	12.6	15.5	15.7
Europe emerging	0.9	0.5	0.4	1.0	0.0	0.0
Africa/Middle East	2.1	2.0	1.0	1.2	0.8	0.9
Greater Asia	**22.7**	**20.8**	**17.9**	**9.0**	**7.7**	**7.9**
Japan	8.4	8.3	7.6	2.1	1.6	3.7
Australasia	5.2	5.0	1.1	1.8	1.9	1.0
Asia developed	5.0	4.3	3.8	3.0	2.1	1.4
Asia emerging	4.1	3.3	5.5	2.2	2.1	1.8
Market classification	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
% Developed markets	93.3	94.9	92.1	96.2	96.6	97.4
% Emerging markets	6.7	5.1	7.9	3.8	3.4	2.6

Source: Morningstar

While most of our portfolios remain overweight developed markets, specifically the US, we have seen a significant increase in the emerging market allocation of all portfolios over the third quarter of 2016. In addition to this, as noted throughout the article, the country a company is based in does not necessarily reflect what should be expected from returns. Many of the underlying holdings within our portfolio have positions in global companies that get large portions of their earnings from outside the home country.

Equity research



Style trends in dividend-income strategies

DIVIDEND-INCOME STRATEGIES HAVE PROVED ESPECIALLY POPULAR OF LATE

Mainly because income-seeking investors have developed a keen appetite for high-yielding investments. This is, however, to be expected given the search for yield in the prevailing low interest rate environment. This is particularly true for developed markets that are still trading at historically low interest rates. Dividend-yielding investments can also provide an income that has the potential to grow at a rate in excess of inflation despite the attractive income distribution that this trend offers. As an equity investment, there is also the potential for capital growth. It is tempting to capture yields by buying stocks with risky dividends given investors' preference for income. This article aims to highlight the pitfalls when constructing a dividend-income strategy. We hope to show which strategies could offer investors the best returns by reviewing the most popular styles or strategies used.

THE HOLY GRAIL IN THE CONSTRUCTION OF A DIVIDEND-INCOME STRATEGY IS TO ACHIEVE A PORTFOLIO WITH BOND- AND EQUITY-LIKE CHARACTERISTICS

Traditional dividend-income strategies gravitate between high current dividend income on the one side of the spectrum and a lower current yield with the expectation of higher dividend growth on the other side. Between these extremes there are numerous other strategies followed by investors. Usually a strategy is combined with a style factor tilt. The tilt towards quality, value and/or momentum is ordinarily gained by applying quantitative, qualitative and technical screens to filter out perceived 'high-risk' investments. In the construction of a dividend-income strategy you want a portfolio with bond-like characteristics (which offers income and capital safety) and equity-like characteristics (which offers capital growth).

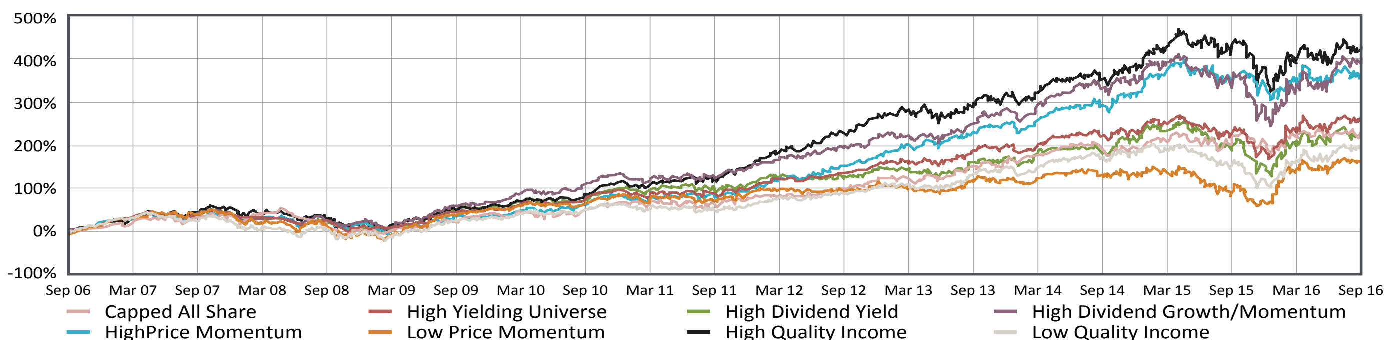
PSG WEALTH RESEARCH METHODOLOGY TO TEST STYLE TRENDS

The PSG Wealth research team has built fictitious portfolios to illustrate the performance of each of the following strategies:

- High dividend yield strategy
- Low dividend yield
- High free cash flow yield
- Low free cash flow yield
- High dividend yield growth/momentum
- Low dividend yield growth / momentum
- High price momentum
- Low price momentum
- High quality income
- Low quality income

Each of these strategies were measured against the performance of the Capped All Share Index and a high yielding universe of shares. The analysts back-tested these dividend-income strategies against all the stocks on the FTSE/All Share Index (ALSI) with a yield higher than the index (excluding the real estate sector). The investments in each strategy were equally weighted and rebalanced on a biannual basis. Each strategy was limited to 20 counters. The research division then tracked the performance of all the identified strategies over a 10-year period. The graph below shows the performance of only those trends the analyst found to be meaningful.

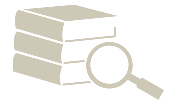
South African income style trends*



*The graph was cleaned to illustrate only the most meaningful trends

Source: PSG Wealth research team

Equity research

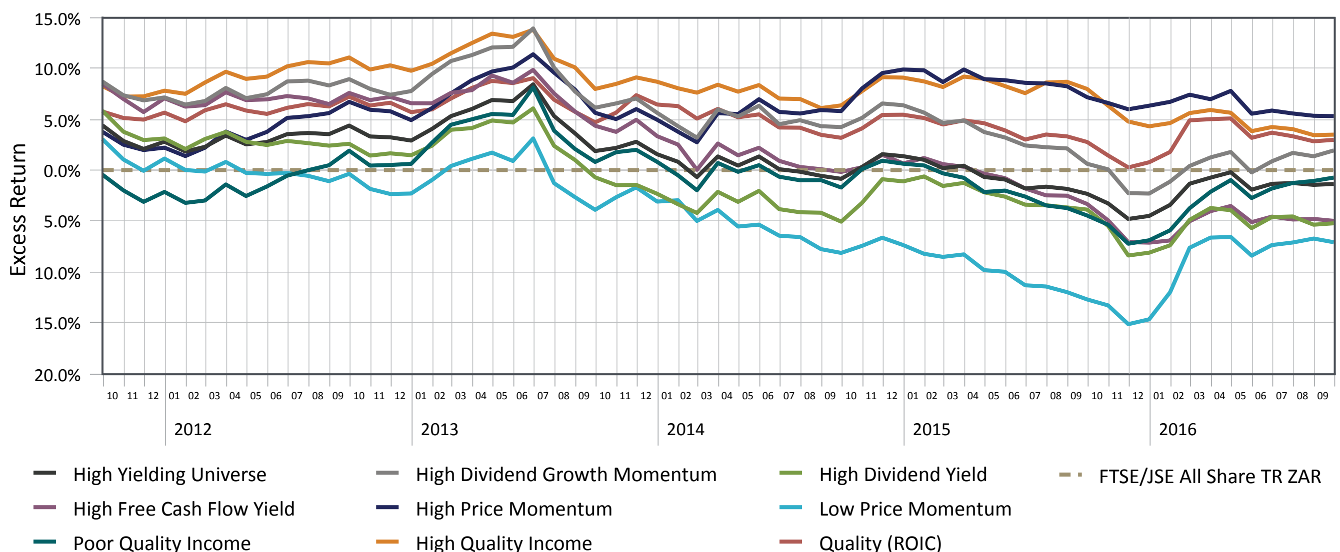


The analyst then used the data from the 10-years shown in the graph above to produce 5-year rolling returns for each of the meaningful trends.

The graph below indicates that no specific strategy outperformed over all of the five-year rolling time periods. However, significant outperformance can be observed in the quality-, price- and dividend momentum strategies.

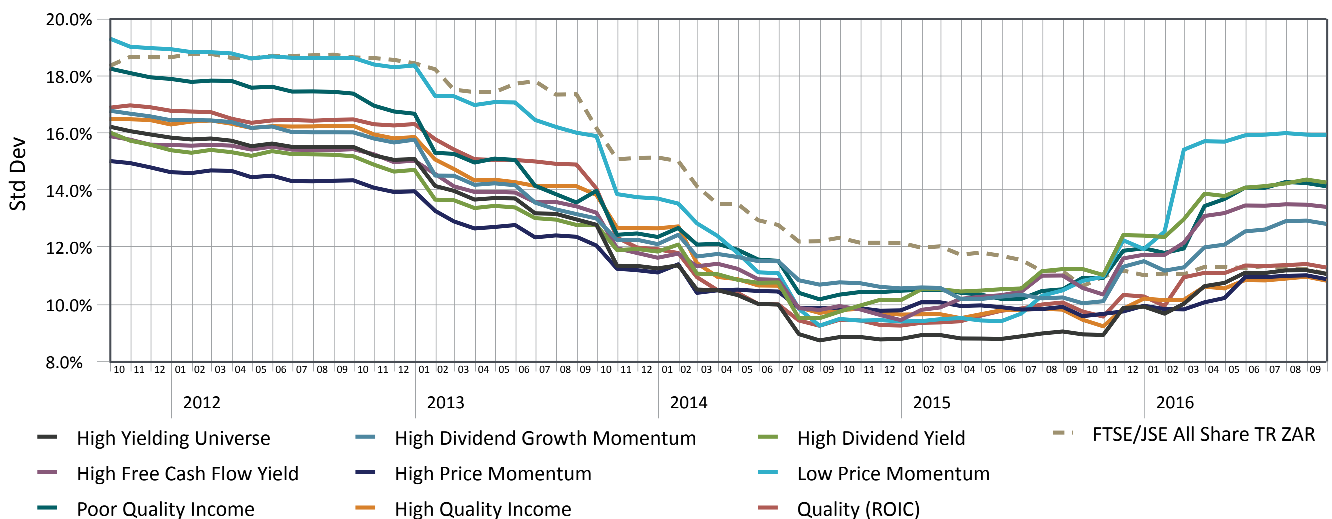
Weak price momentum and high dividend yields have, not surprisingly, taken the wooden spoon in these scenarios. This subject has also prompted numerous studies. It is also worthwhile to note that the high yielding universe was significantly less volatile than the Capped All Share Index, as indicated by its standard deviation in the graph below.

5-year rolling alpha



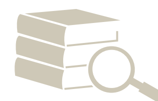
Source: PSG Wealth research team

5-year rolling volatility (standard deviation)

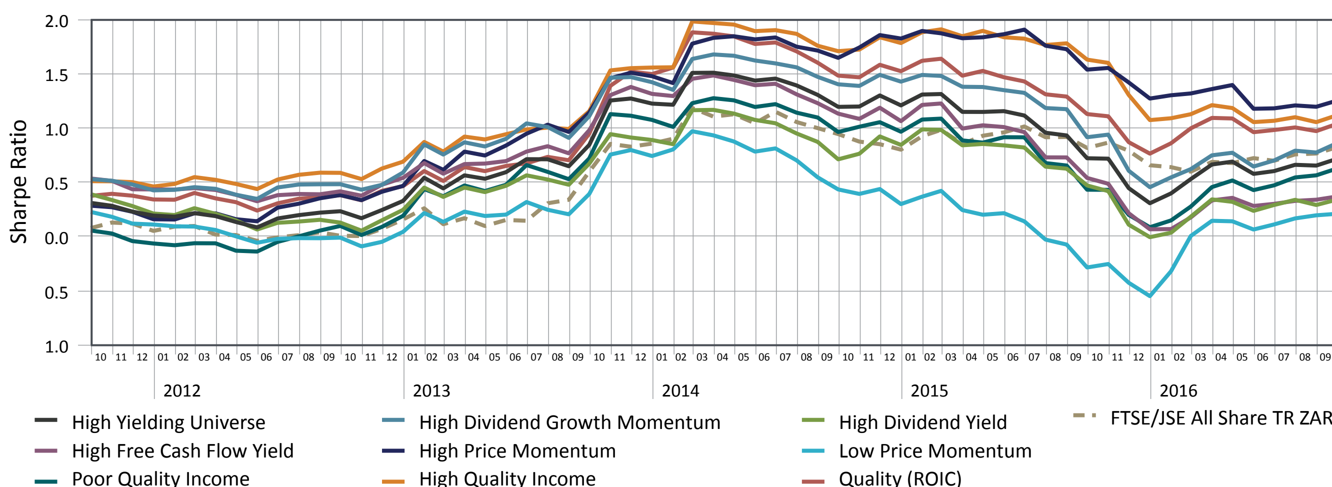


Source: PSG Wealth research team

Equity research



5-year rolling sharpe ratio



Source: PSG Wealth research team

Our research division is of the opinion that investors need to look past dividend yields and historical performance when selecting appropriate dividend strategies. While it is important to look at historical data to see what has worked in the past, our analysts prefer to use it to form a view about why it worked, and under what circumstances it might not work. The PSG Wealth research team believes it is prudent to ascertain if the conditions that contributed to the strategy's success is still relevant before settling on a final approach.

Types of style trends

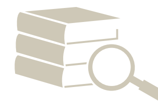
1. DIVIDEND INCOME

These investments are typically made in large mature operations with limited expected growth given the life cycle of the business. Accordingly, the potential for dividend growth should be below average. Here the research division selected stocks that offer the highest yields in the high yielding universe. The investments typically have a value bias while trading on lower valuation multiples. A caveat to consider is that companies with high dividend payouts are more likely to cut their dividends than those with a lower payout ratio. In this scenario a high share of earnings are paid out as a dividend, which creates an environment conducive to financial distress. This can result in a smaller buffer of protection, should earnings fall.

Investors typically sacrifice good business fundamentals for yield, but dividend yields that look too good to be true usually are. When too much focus is placed on the yield level, funds are forced to chase 'bad dividends' that push up volatility and increases drawdown risk. This is specifically relevant to cyclical counters. Recent experience with our commodity counters illustrate these concerns – where income and capital are placed under pressure because share prices decline ahead of dividend cuts. The high dividend strategy underperformed significantly compared to the high yield universe and the Capped All Share Index during our research.

In addition, it displayed the highest volatility, resulting in a poor risk-adjusted return. In this regard, dividend yields have proven to be a poor measure of value, and typically, the least useful standalone valuation metric. A high free cash flow yield, however, produced a healthier return than the high dividend yield. This metric is also more sensible.

Equity research



2. DIVIDEND GROWTH

Dividend growth investors have less exposure to lower earnings growth investments because their focus is on lower current dividends in exchange for the potential of a higher payout in future. Here we selected the counters with the highest three-year dividend growth forecasts, based on consensus estimates. Income to investors tend to be more sustainable as these firms pay out a smaller portion of their earnings as a dividend. This does not mean that these investments are without risks. These investments typically trade on higher valuation multiples given that the growth has been priced in.

Investors typically focus their attention on growth and not valuations. Here investors run the risk that company management is trying to sustain the unsustainable by increasing dividends in excess of their earnings, which could leave dividend cover precariously low. This could prove especially risky if the current margins are above the trend or when an economic slowdown looms. Their share prices (capital) are at risk of significant decline if their earnings fail to live up to the more demanding expectations priced into the investments. This strategy managed to produce risk-adjusted returns ahead of the high yielding universe and Capped All Share Index over most periods but was not the top performing strategy in terms of risk or return.

3. QUALITY INCOME

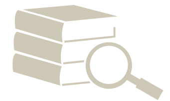
This strategy attempts to improve the sustainability of returns by focusing on investments with a durable competitive advantage, long dividend growth history, above average profitability, strong cash generation and a healthy balance sheet. Sustaining the dividend is pivotal for this strategy to be successful. In other words, a dividend income that is optimised for underlying business economics and a strong capital structure. This ensures a focus on factors that improves the success of the strategy, but is not historically priced into investments.

In the illustration, strong underlying business economics were identified through a high return on equity (ROE), a high return on invested capital (ROIC) and strong cash conversion capabilities. The strategy was consistently one of the top returning strategies as indicated by its five-year rolling alpha and its five-year rolling sharpe ratio.

4. PRICE MOMENTUM

This style proved relevant as it illustrates markets' ability of pricing-in future expectations. Thus, as expectations increase so too should share prices. High price momentum counters were defined as investments with a return better than the benchmark over a six-month period. Price momentum proved to be one of the best performing strategies with the highest returns based on the analysis. This style can also be applied as an overlay or tilt to enhance the return of any of the above-mentioned strategies.

Equity research



The highest long-term returns are achieved by following the strategies that display more consistency in their performance

The table below indicates that even weak strategies, like for example the low price momentum strategy, do sometimes outperform.

	Capped All Share	High Yielding Universe	High Quality Income	High Dividend Growth / Momentum	High Price Momentum	Low Dividend Yield	Low Free Cash Flow Yield	Low Dividend Growth / Momentum	High Free Cash Flow Yield	High Dividend Yield	Low Quality Income	Low Price Momentum
2016 Quartile rank	3	2	4	2	4	1	1	4	3	3	2	1
2015 Quartile rank	1	3	1	2	1	4	3	2	3	2	4	4
2014 Quartile rank	2	2	2	1	1	3	3	4	4	3	1	4
2013 Quartile rank	1	2	3	3	1	1	4	2	3	4	2	4
2012 Quartile rank	4	3	1	2	1	2	2	1	3	4	3	4
2011 Quartile rank	3	3	1	2	2	4	4	2	1	1	4	3
2010 Quartile rank	3	3	3	1	2	2	1	1	2	4	4	4
2009 Quartile rank	4	2	3	1	4	3	3	4	2	1	1	2
2008 Quartile rank	4	3	2	3	2	1	1	2	1	3	4	4
2007 Quartile rank	3	3	1	2	4	3	1	4	1	2	4	2

*Green numbers represent top quartile performance.
Source: PSG Wealth research team

Research shows that strategies that employ dividend momentum, price momentum and quality have consistently outperformed over the review period

Historically low interest rates and lofty equity valuations are making it increasingly difficult to generate a sensible return from equities. However, we believe the process above highlights the need to prioritise sustainability over quantum in an income strategy. Low-risk, high-quality companies have been better stocks to invest in than high-risk, low-quality ones. It makes sense to buy great cash flow generating businesses at sensible yields. It is the future cash flows that count and the price that you pay for that cash flow that drives overall investment returns. This approach should result in a dividend strategy that is less volatile and has a better-than-average chance of outperforming its benchmark, resulting in satisfactory risk-adjusted returns.

Fixed income

Rate normalisation is expected to continue, but at an impeded pace

THE PRIME RATE HAS STAYED AT 10.5% SINCE MARCH THIS YEAR

This is the same level it was in August 2009. Although rate normalisation has been topical for some time, South Africa's official short-term interest rate has actually only increased by 2% over the last four years. At that stage (July 2012) rates were at 30-year lows of about 8.50%.

Repo rate increases since 2006

Year	Day and 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

At that stage the Monetary Policy Committee (MPC) of the South African Reserve Bank followed very accommodative monetary policies, especially after the strain placed on our economy during the global financial crisis. Interest rates were slashed by 5% from 15.5% to 10.5% from June 2008 to August 2009. Although the general outlook on interest rates has been negative (especially after the MPC indicated earlier this year that it intends to normalise rates as required), the absolute cost of finance in the economy remains fairly accommodative, relative to long-term averages.

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. We therefore expect that if inflation breaches the 6% upper target limit by a material margin, the MPC will proceed with small incremental rate increases. If the breaches are trivial, or if rates are slightly below the upper target of 6%, we certainly expect the MPC to follow a more accommodative stance given the poor economic growth we have seen.

When the rising interest rate cycle does start to take place, we naturally expect that it will 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 that the impact of these individual hikes in isolation will contribute excessive volatility to capital markets.

The cost of capital will, however, continue to rise as interest rates increase and bond yields adjust accordingly. In addition, 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 cost of this second round may be remains uncertain.

Fixed income

IT WOULD BE WISE TO POSITION INVESTMENTS FOR UNCERTAINTY

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

We are in favour of increasing our position in cash and short-dated sovereign debt given the conditions mentioned above. We maintain a somewhat more negative view on longer-dated nominal bonds.

Our positioning

Metric	Position	Direction	Reasoning
Modified duration	Underweight	-	Interest rate risk
Credit risk	Underweight	-	Deteriorating domestic economic climate
SA cash	Neutral	+	Real yields entering positive territory
SA sovereign debt	Neutral	+	Negative economic outlook by rating agencies priced in
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 research team

Property commentary

Flat performance for local property over the past quarter

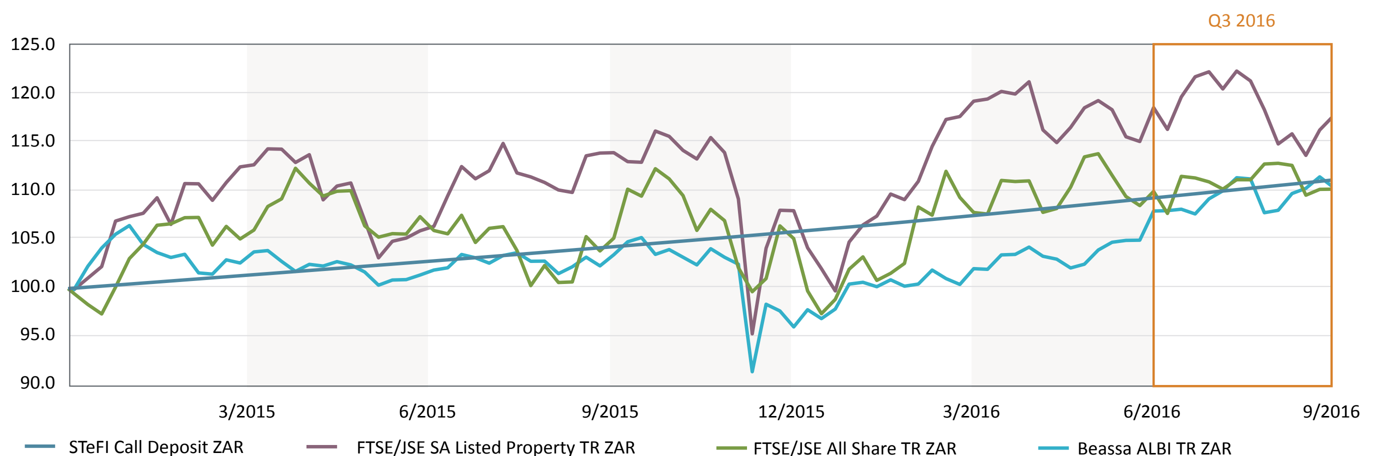
The South African Listed Property Index (SAPY) was the biggest loser among the four traditional asset classes for the second consecutive quarter. All eyes were on central banks in July. Investors expected a rate cut by the Bank of England (BoE) and another stimulus package announcement by the Bank of Japan (BoJ). However at the July policy meetings, the US Federal Reserve (Fed), the BoE and the South African Reserve Bank (SARB) kept their interest rates unchanged. As a result global equity markets rallied, while bond yields fell to historic lows, with the yields on 10-year government bonds in Germany, Switzerland and Japan falling below zero. Further strengthening of the rand led to lower domestic bond yields and supported a 3.26% return for the SAPY in July.

Investors were net buyers of our local government bonds following the results of our local municipal elections. The yield of the R186 bond fell as low as 8.4% during the month of August. However, leading up to the end of August, news broke that the Hawks were investigating finance minister, Pravin Gordhan, which further increased political uncertainty and the risk of a possible credit downgrade by ratings agencies in December. This combined with the threat of an interest rate hike in the United States before the end of the year, created a sharp sell-off in the local bond market with the yield of the R186 breaching the 9% level. The SAPY followed the lower bond market and reversed its earlier gains, declining by 4.89% in August.

Moody's announced in September that the probability of a downgrade of South Africa's credit rating was less than 50%. This news boosted the rand and the SAPY, which returned 1.09% for September. However this was not sufficient to offset the sharp drop in August and the SAPY ended the quarter in the red (-0.73%).

The SAPY delivered a volatile but flat performance for the third quarter compared to the drop of 0.73% at the end of the second quarter of the year. South African bonds was the best performer out of the four traditional asset classes for the second consecutive quarter, returning 3.42% at the end of September. On a year-to-date (YTD) basis, these bonds returned a solid 15.05%. Local cash was the second best performer over the quarter (+1.71%), followed by domestic equities (+0.48%). Although the yield to maturity on the local R186 bond was volatile, it still performed well, falling by four basis points to 8.66% (compared to 8.7% on 1 July 2016). As of 30 September, the historic rolled income yield of the SAPY stood at 5.96%.

Investment growth for third quarter



Source: Morningstar Direct

Property commentary

REPORTING SEASON

The reporting season kicked off in August with most companies reporting either half- or full-year results. Here are some of the highlights:

Company	Market cap (R mil)	Reporting period	DPS growth	DPS forecast
Capital and Counties	40 935.97	Interim	0.0%	n/a
Emira	7 581.67	Full Year	8.8%	-2.0%
Fortress Income - A	18 251.25	Full Year	5.0%	5.0%
Fortress Income - B	32 962.35	Full Year	91.0%	22.0%
Growthpoint	69 568.75	Full Year	6.0%	6.0%
Hyprop	29 937.17	Full Year	14.9%	10.0%
Intu Properties	66 994.81	Interim	0.0%	n/a
MAS Real Estate	7 335.62	Full Year	34.0%	30.0%
New Europe Property (NEPI)	49 736.35	Interim	6.2%	15.0%
Resilient	45 834.63	Full Year	25.0%	14% to 16%
Rockcastle	34 038.07	Interim	8.2%	11% to 13%
SA Corp	12 622.14	Interim	9.1%	9.0%

Source: Morningstar Direct, company results, Catalyst Fund Managers

OUR TAKE

We predicted in our previous quarterly review that the effects of a lacklustre local economy will start to filter through in this reporting season. In summary, we found that all the subsectors have fundamentally deteriorated with the office sector the worst hit. Retaining tenants in general have become a difficult task, and those with improving tenant retention rates, did so at the expense of lower escalations on the renewal of rentals (rental reversions). New lease escalations across all subsectors are also trending lower. Many tenants are experiencing cash constraints and as such tenant arears have also deteriorated to an extent. Our research shows that the most resilient subsector remains retail, particularly quality, dominant retail assets. The density of trading in these retail shopping centres remain healthy with modest growth. Retail vacancies continue to show improvement and are also the lowest compared to the other subsectors. Office vacancies remain the highest. Distribution forecasts in general for the next financial year are significantly lower than for the 2016 financial year.

CORPORATE ACTIVITY

A number of property companies took advantage of the higher-than-normal share prices and lower yields in July, by raising capital through accelerated book builds. These included, amongst others, companies like Hyprop (who raised R700m), New Europe Property (NEPI who raised R2.5bn), Redefine (raised R1.5bn) and MAS Real Estate (raised R500m). In the period under review a few international property companies looked to the Johannesburg Stock Exchange (JSE) to tap into local appetite for offshore property. Hammerson, the third largest real estate investment trust in the UK, acquired a secondary listing on the JSE. This listing was made possible after recent amendments to the Index Ground rules of the JSE. The new amendments now lowers the hurdle for eligible inward-listed shares to be included in JSE indices.

Echo Polska Properties (EPP), in which Redefine Properties holds a strategic 49.9% stake, listed on the Luxembourg Stock Exchange (LuxSE) in August and the Johannesburg Stock Exchange (JSE) in September 2016. Redefine also announced its intention to acquire all outstanding shares of Pivotal by way of a scheme of arrangement. This added property assets worth R13bn to its portfolio. Pivotal shareholders will receive approximately 138.54 Redefine shares and 9.38 EPP shares for every 100 Pivotal shares held.

Liberty also plans to list a portion of its property portfolio on the JSE as Liberty Two Degrees (listed company). Liberty aims to raise R4bn in new capital with R6bn assets from Liberty Property Portfolio.

Vukile, Arrowhead, and Synergy have also concluded agreements which will effectively reposition Synergy into a high-yielding, high-growth fund. Its internally managed portfolio will now consist of retail, office and industrial assets which will be renamed GemGrow Properties Limited.

BEST PERFORMERS

Domestic-heavy property companies topped the charts in the third quarter. The results were driven by local corporate activity with Rebosis (+13.5%), SACorp (+10%), Vukile (+10%) and Arrowhead (+9.9%) all announcing acquisition or consolidation deals. While the continued devaluation of the sterling penalised those with United Kingdom asset exposure such as Capital & Regional (-11.1%), Capital & Counties (-11.1%),

Property commentary

Stenprop (-9.3%) and Intu (-7.5%). Furthermore, the strength of the rand also contributed to a weaker performance for some of the rand-hedged counters such as MAS Real Estate (-8.5%) and NEPI (-5.6%).

Top 10 best performers

Rank	Company	Q3 return (cumulative)
1	Emira Property Fund Ltd	13.8%
2	Rebosis Property Fund Ltd	13.5%
3	SA Corporate Real Estate Fund	10.0%
4	Vukile Property Fund Ltd	10.0%
5	Arrowhead Properties Ltd Class A	9.9%
6	Accelerate Property Fund Ltd	8.2%
7	Fortress Income Fund Ltd Class A	7.8%
8	Investec Australia Property Fund	7.0%
9	Octodec Investments Ltd	5.4%
10	Rockcastle Global Real Estate Co Ltd	4.8%

Source: Morningstar Direct

Top 10 worst performers

Rank	Company	Q3 return (cumulative)
1	Resilient REIT Ltd	-11.1%
2	Capital & Regional PLC	-11.1%
3	Capital & Counties Properties PLC	-11.1%
4	Stenprop Ltd	-9.3%
5	MAS Real Estate Inc	-8.5%
6	Attacq Ltd	-8.4%
7	Intu Properties PLC	-7.5%
8	Fortress Income Fund Ltd Class B	-6.5%
9	The Pivotal Fund Ltd	-6.1%
10	New Europe Property Investments PLC	-5.6%

Source: Morningstar Direct

GLOBAL LISTED PROPERTY

The FTSE EPRAN/NAREIT Developed Rental Index ended the quarter in the red, with a net total return of -5.74% (in USD). The worst performing listed real estate market was Italy, with a double digit decline of 10.57% for the quarter, followed by Canada with a total negative return (in USD) of 10.13%.

Hong Kong topped the log for the best performing listed real estate market and recorded a total return of 9.47% (in USD). This was despite a decline in visitor and retail sales in the region. Luxury retail sales declined by more than 20% from the previous year. The necessity shopping category recorded low single digit growth, while retail landlords continued to focus on signing new leases significantly above expiring rent levels. Low vacancy rates and strong demand for space from Chinese firms led to high single digit market rental growth in the central office market over the past year.

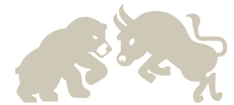
In Australia, the real estate investment trust (REIT) reporting season concluded during August, with the majority of results in line with market expectations. However, the earnings outlook softened, with the majority of the companies anticipating muted earnings growth, with the exception of residential developers. Australia recorded a drop of 5.31% in their net total return (in USD) for the quarter.

POSITIONING

We anticipate seeing the effect of a lacklustre local economy to start to filter through reporting results going forward. Especially as sluggish demand for vacant space continues to put pressure on rentals. Regarding Brexit, our concerns mainly revolve around property companies with exposure to London office space. However, the full impact on UK property values remains uncertain. We will continue to monitor the risks of illiquidity in the South African listed property sector, which remains a general concern. We remain of the view that the interest rate cycle will impact domestic economic strength, affordability and sentiment. 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)
- utilisation of structures that offer superior liquidity, like REITs
- superior distribution growth track records.

Preference shares



The FTSE/JSE Preference Share Index generated a gain of 2.2% in the third quarter following the 9.0% gain in the second quarter of the year. This strong recovery in prices brings the total one-year return to 13.4%. The recent push is surely welcomed by preference share investors, given that the total return for 2015 came in at a meager 2.6%.

Returns on income orientated asset classes

	1 month	3 months	6 months	1 year
Beassa 1-3 Year TR ZAR	1.3	2.2	5.1	8.0
Beassa 3-7 Year TR ZAR	2.1	2.9	6.8	9.2
Beassa 7-12 Year TR ZAR	2.9	3.2	7.4	7.9
FTSE/JSE Preference Share TR ZAR	3.0	2.2	11.4	13.4
FTSE/JSE SA Listed Property TR ZAR	1.1	-0.7	-1.2	3.8

Source: i-Net BFA

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

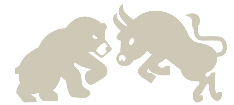
Domestic preference shares characteristics

30/09/2016	STANDARD	ABSA	FIRSTRAND	NEDBANK	INV-LTD	INV-BANK	INV-PREF	CAPITEC	SASFIN
VALUE	SBPP	ABSP	FSRP	NBKP	INPR	INLP	INPPR	CPIP	SFNP
Price	R 86.00	R 782.46	R 83.50	R 9.15	R 79.60	R 86.20	R 102.01	R 93.95	R 77.50
Yield as % of prime	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	R 0.75	R 6.85	R -	R 0.12	R 2.84	R 3.04	R 3.47	R 0.48	R 0.14
Clean price	R 85.25	R 775.61	R 83.50	R 9.03	R 76.76	R 83.16	R 98.54	R 93.47	R 77.36
LIQUIDITY	SBPP	ABSP	FSRP	NBKP	INPR	INLP	INPPR	CPIP	SFNP
Market cap (Rm)	R 4,583 m	R 3,869 m	R 3,758 m	R 3,279 m	R 2,564 m	R 1,332 m	R 29 m	R 179 m	R 144 m
Avg monthly trade (Rm)	R 71.83 m	R 55.39 m	R 52.18 m	R 112.52 m	R 33.05 m	R 17.58 m	R 2.24 m	R 4.18 m	R 3.85 m
% of market cap traded monthly	1.58%	1.43%	1.39%	3.43%	1.29%	1.32%	7.82%	2.34%	2.68%
Effective yield as a % of prime	90.33%	90.33%	90.49%	92.23%	101.33%	100.21%	96.41%	89.15%	106.65%
Effective yield	9.48%	9.48%	9.50%	9.68%	10.64%	10.52%	10.12%	9.36%	11.20%

Source: Grindrod Bank

PSG Wealth

Preference shares

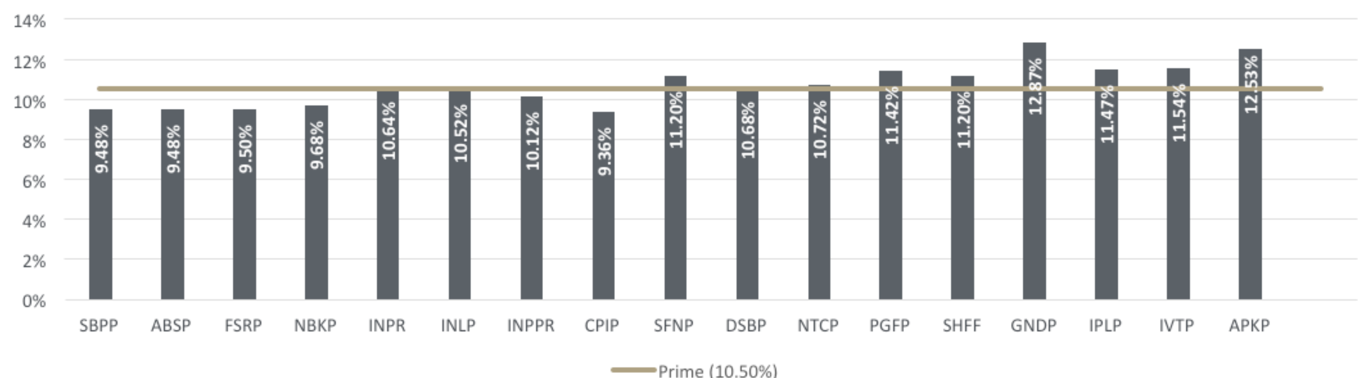


Domestic preference shares characteristics

30/09/2016	DISCOVERY	NETCARE	PSG	STEINHOFF	GRINDROD	IMPERIAL	INVICTA	ASTRAPAK
VALUE	DSBP	NTCP	PGFP	SHFF	GNDP	IPLP	IVTP	APKP
Price	R 99.05	R 84.51	R 77.10	R 81.68	R 72.50	R 76.00	R 95.70	R 75.00
Yield as % of prime	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	R 0.78	R 3.68	R 0.48	R 4.34	R 0.68	R 0.47	R 2.90	R 0.51
Clean price	R 95.10	R 80.83	R 76.62	R 77.34	R 71.82	R 75.53	R 92.80	R 74.49
LIQUIDITY	DSBP	NTCP	PGFP	SHFF	GNDP	IPLP	IVTP	APKP
Market cap (Rm)	R 792 m	R 549 m	R 1,343 m	R 1,225 m	R 537 m	R 345 m	R 718 m	R 113 m
Avg monthly trade (Rm)	R 12.30 m	R 21.08 m	R 19.17 m	R 16.24 m	R 12.89 m	R 13.94 m	R 16.99 m	R 2.87 m
% of market cap traded monthly	1.55%	3.84%	1.43%	1.33%	2.40%	4.04%	2.37%	2.55%
Effective yield as a % of prime	101.76%	102.06%	108.76%	106.68%	122.53%	109.23%	109.92%	119.33%
Effective yield	10.68%	10.72%	11.42%	11.20%	12.87%	11.47%	11.54%	12.53%

Source: Grindrod Bank

Effective yield



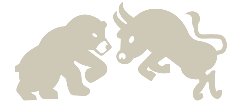
Source: Grindrod Bank

Some market capitalisations are well below R1 bn, and some trading volumes remain very low in absolute terms. Investors should be mindful of potential liquidity constraints on certain preference shares. In many cases it is more sensible to consider a unitised product consisting of a diversified selection of preference shares. These collective investment scheme structures also offer additional peace-of-mind in terms of approval from the Financial Services Board, improved liquidity and ongoing portfolio management.

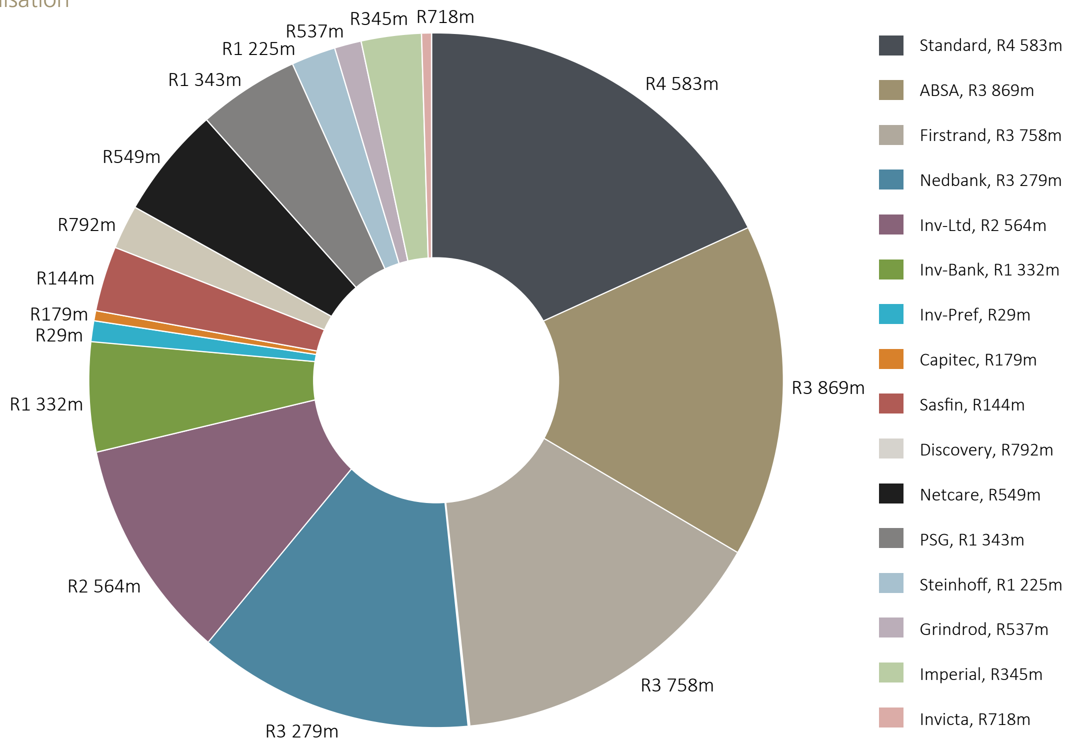
The first announcement by one of the big domestic banks (Nedbank Group Limited) was on 14 April. Nedbank announced that they intend to start a buy-back programme, but did not indicate the size of the buy-back. This is substantial, because Nedbank is the fourth-biggest issue (R3.28bn) on the FTSE/JSE Preference Share Index.

PSG Wealth

Preference shares



Market capitalisation



Source: Grindrod Bank

CURRENT RISKS FOR PREFERENCES SHARES

Although preference 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 eventually normalise, we feel that there are some significant capital risks in this asset class. With the domestic economy struggling, any further downgrades to 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). 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%).

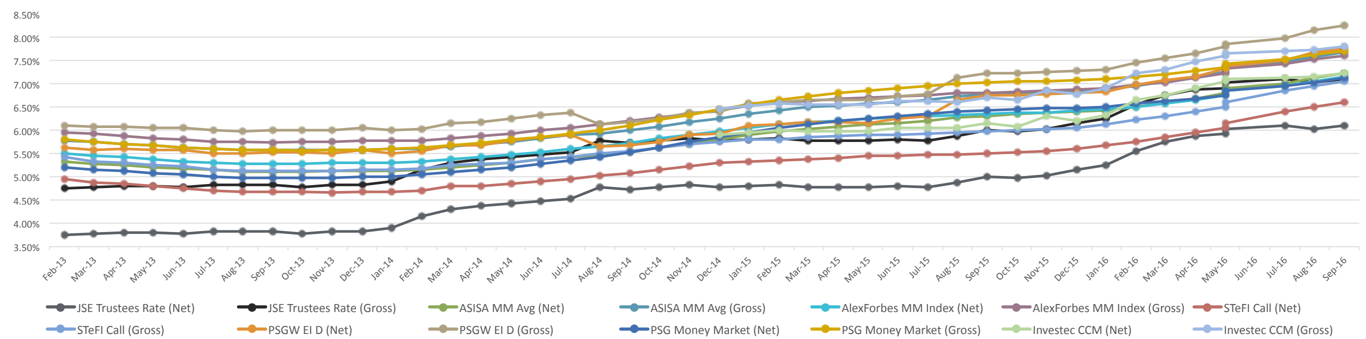
Over the last year we have communicated that we expect some banks to repurchase their preference shares in the open market or incentivise investors to accommodate any changes to the legal risks in the listing documents.

Cash management options

If you want to hold on to cash, then the PSG Wealth Enhanced Interest Fund remains one of the most appropriate investment vehicles for returns and flexibility

The effective after-cost yields for both the PSG Wealth Enhanced Interest Fund (7.77%) and the PSG Money Market Fund (7.13%) are currently well above the SteFI call rate (6.60%). The average yield of the ASISA Money Market Fund peer group is 7.23%.

Rate comparison (Net of fees)



	Feb-13	Mar-13	Apr-13	May-13	Jun-13	Jul-13	Aug-13	Sep-13	Oct-13	Nov-13	Dec-13	Jan-14	Feb-14	Mar-14	Apr-14	May-14	Jun-14	Jul-14	Aug-14	Sep-14	Oct-14	Nov-14
JSE Trustees Rate (Net)	3.75%	3.79%	3.80%	3.80%	3.79%	3.82%	3.83%	3.83%	3.78%	3.82%	3.82%	3.90%	4.16%	4.31%	4.39%	4.42%	4.49%	4.54%	4.78%	4.74%	4.79%	4.82%
JSE Trustees Rate (Gross)	4.75%	4.79%	4.80%	4.80%	4.79%	4.82%	4.83%	4.83%	4.78%	4.82%	4.82%	4.90%	5.16%	5.31%	5.39%	5.42%	5.49%	5.54%	5.78%	5.74%	5.79%	5.82%
ASISA MM Avg (Net)	5.32%	5.29%	5.25%	5.21%	5.18%	5.14%	5.12%	5.11%	5.11%	5.12%	5.13%	5.14%	5.16%	5.20%	5.25%	5.31%	5.37%	5.44%	5.46%	5.54%	5.63%	5.71%
ASISA MM Avg (Gross)	5.78%	5.75%	5.71%	5.67%	5.64%	5.60%	5.58%	5.57%	5.57%	5.58%	5.59%	5.60%	5.62%	5.66%	5.71%	5.77%	5.83%	5.90%	5.92%	6.00%	6.09%	6.17%
AlexForbes MM Index (Net)	5.51%	5.46%	5.42%	5.38%	5.34%	5.31%	5.29%	5.28%	5.29%	5.30%	5.32%	5.31%	5.33%	5.37%	5.42%	5.48%	5.54%	5.59%	5.66%	5.74%	5.82%	5.90%
AlexForbes MM Index (Gross)	5.97%	5.92%	5.88%	5.84%	5.80%	5.77%	5.75%	5.74%	5.75%	5.76%	5.78%	5.77%	5.79%	5.83%	5.88%	5.94%	6.00%	6.05%	6.12%	6.20%	6.28%	6.36%
STeFI Call (Net)	4.96%	4.87%	4.86%	4.80%	4.77%	4.70%	4.67%	4.68%	4.68%	4.67%	4.68%	4.69%	4.71%	4.80%	4.81%	4.85%	4.91%	4.96%	5.04%	5.09%	5.16%	5.24%
STeFI Call (Gross)	5.42%	5.33%	5.32%	5.26%	5.23%	5.16%	5.13%	5.14%	5.14%	5.13%	5.14%	5.15%	5.17%	5.26%	5.27%	5.31%	5.37%	5.42%	5.50%	5.55%	5.62%	5.70%
PSGW EI D (Net)	5.64%	5.59%	5.61%	5.58%	5.57%	5.52%	5.50%	5.54%	5.54%	5.52%	5.58%	5.52%	5.55%	5.68%	5.69%	5.79%	5.86%	5.90%	5.66%	5.69%	5.77%	5.90%
PSGW EI D (Gross)	6.12%	6.07%	6.09%	6.06%	6.05%	6.00%	5.98%	6.02%	6.02%	6.00%	6.06%	6.00%	6.03%	6.16%	6.17%	6.27%	6.34%	6.38%	6.14%	6.17%	6.25%	6.38%
PSG Money Market (Net)	5.21%	5.16%	5.13%	5.09%	5.05%	5.01%	4.99%	4.98%	4.98%	4.98%	4.99%	5.02%	5.05%	5.10%	5.15%	5.21%	5.28%	5.34%	5.43%	5.52%	5.63%	5.75%
PSG Money Market (Gross)	5.80%	5.75%	5.72%	5.68%	5.64%	5.60%	5.58%	5.57%	5.57%	5.57%	5.58%	5.61%	5.64%	5.69%	5.74%	5.80%	5.87%	5.93%	6.02%	6.11%	6.22%	6.34%
Investec CCM (Net)																						
Investec CCM (Gross)																						

	Dec-14	Jan-15	Feb-15	Mar-15	Apr-15	May-15	Jun-15	Jul-15	Aug-15	Sep-15	Oct-15	Nov-15	Dec-15	Jan-16	Feb-16	Mar-16	Apr-16	May-16	May-16	Jul-16	Aug-16	Sep-16
JSE Trustees Rate (Net)	4.78%	4.81%	4.84%	4.79%	4.79%	4.77%	4.80%	4.78%	4.88%	5.01%	4.98%	5.03%	5.16%	5.25%	5.55%	5.75%	5.89%	5.92%	6.04%	6.10%	6.04%	6.10%
JSE Trustees Rate (Gross)	5.78%	5.81%	5.84%	5.79%	5.79%	5.77%	5.80%	5.78%	5.88%	6.01%	5.98%	6.03%	6.16%	6.25%	6.55%	6.75%	6.89%	6.92%	7.04%	7.10%	7.04%	7.10%
ASISA MM Avg (Net)	5.80%	5.90%	5.98%	6.04%	6.08%	6.12%	6.16%	6.20%	6.28%	6.32%	6.35%	6.38%	6.41%	6.43%	6.51%	6.60%	6.69%	6.80%	6.91%	7.02%	7.13%	7.23%
ASISA MM Avg (Gross)	6.26%	6.36%	6.44%	6.50%	6.54%	6.58%	6.62%	6.66%	6.74%	6.78%	6.81%	6.84%	6.87%	6.89%	6.97%	7.06%	7.15%	7.26%	7.37%	7.48%	7.59%	7.69%
AlexForbes MM Index (Net)	5.98%	6.06%	6.14%	6.18%	6.22%	6.25%	6.28%	6.31%	6.34%	6.36%	6.37%	6.39%	6.42%	6.46%	6.51%	6.58%	6.67%	6.77%	6.87%	6.97%	7.07%	7.16%
AlexForbes MM Index (Gross)	6.44%	6.52%	6.60%	6.64%	6.68%	6.71%	6.74%	6.77%	6.80%	6.82%	6.83%	6.85%	6.88%	6.92%	6.97%	7.04%	7.13%	7.23%	7.33%	7.43%	7.53%	7.62%
STeFI Call (Net)	5.29%	5.34%	5.36%	5.39%	5.41%	5.45%	5.45%	5.47%	5.49%	5.51%	5.54%	5.56%	5.60%	5.67%	5.77%	5.85%	5.95%	6.05%	6.16%	6.41%	6.51%	6.60%
STeFI Call (Gross)	5.75%	5.80%	5.82%	5.85%	5.87%	5.91%	5.91%	5.93%	5.95%	5.97%	6.00%	6.02%	6.06%	6.13%	6.23%	6.31%	6.41%	6.51%	6.62%	6.87%	6.97%	7.06%
PSGW EI D (Net)	5.94%	6.11%	6.13%	6.18%	6.19%	6.17%	6.26%	6.30%	6.66%	6.75%	6.76%	6.79%	6.81%	6.84%	6.97%	7.09%	7.17%	7.34%	7.38%	7.51%	7.68%	7.77%
PSGW EI D (Gross)	6.42%	6.59%	6.61%	6.66%	6.67%	6.65%	6.74%	6.78%	7.14%	7.23%	7.24%	7.27%	7.29%	7.32%	7.45%	7.57%	7.65%	7.82%	7.86%	7.99%	8.16%	8.25%
PSG Money Market (Net)	5.86%	5.97%	6.06%	6.14%	6.21%	6.27%	6.32%	6.37%	6.41%	6.43%	6.46%	6.48%	6.49%	6.51%	6.57%	6.63%	6.69%	6.77%	6.86%	6.95%	7.04%	7.13%
PSG Money Market (Gross)	6.45%	6.56%	6.65%	6.73%	6.80%	6.86%	6.91%	6.96%	7.00%	7.02%	7.05%	7.07%	7.08%	7.10%	7.16%	7.22%	7.28%	7.36%	7.45%	7.54%	7.63%	7.72%
Investec CCM (Net)	5.90%	5.96%	6.01%	5.98%	5.98%	5.98%	6.07%	6.06%	6.05%	6.15%	6.09%	6.30%	6.21%	6.33%	6.66%	6.75%	6.91%	7.05%	7.10%	7.13%	7.16%	7.24%
Investec CCM (Gross)	6.47%	6.53%	6.58%	6.55%	6.55%	6.55%	6.64%	6.63%	6.62%	6.72%	6.66%	6.87%	6.78%	6.90%	7.23%	7.32%	7.48%	7.62%	7.67%	7.70%	7.73%	7.81%

Source: PSG Wealth research team, Morningstar, JSE, Investec

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 mandate of the PSG Wealth Enhanced Interest Fund still maintains a slightly higher duration profile to enhance yield. The JSE trustees rate (net 6.10%) offers a reasonable yield for investors who wish to keep cash in their stockbroking accounts. This will enable swift action if and when opportunities in equity investments present themselves.

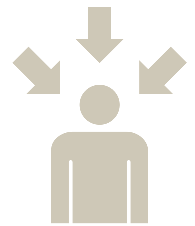
INTEREST RATE HIKES PROBABLY DELAYED FOR NOW

On 30 June, the South African forward rate curve was pricing in rate hikes totalling 0.50% over the next three meetings by the South African Reserve Bank's Monetary Policy Committee (MPC) (scheduled for July, September and November). Previously we indicated that we were of the opinion that these hikes were unlikely to materialise given prevailing weak economic conditions and the fact that inflation has only moderately breached its upper target limit at the time. Subsequently the MPC left rates unchanged following the committee's meetings during July and September. We maintain the view that the outcome of November's meeting will also be to keep rates unchanged.

CASH PLAYS A STRATEGIC ROLE IN THE PORTFOLIO MANAGEMENT PROCESS

Although cash rates are only marginally positive in real terms, we feel that cash is playing an increasingly important role in the portfolio management process. Cash helps to reduce overall portfolio volatility. It also gives active managers access to funds so that they can take advantage of investment opportunities in equity markets as volatility increases.

That being said, we strongly discourage clients from investing solely in cash in an attempt to time markets. By adopting such a strategy, a whole range of other unintended risks are introduced to longer-term wealth creation prospects. Both longevity risk and inflation risk could increase to excessive levels. Please refer to our special report on the topic on page 4 of our June edition of the *PSG Wealth Monthly Insights* by clicking here.



Theme spotlight

Active, passive or gamma

There has been a plethora of opinions and pieces on which investment strategy is best – active or passively managed funds. The question is whether these discussions truly lead to investor success. According to one author from Morningstar this should not be the main concern: "Active versus passive has been an overhyped sideshow. Disciplining investors to hold out-of-favour assets, to not chase hot products, to rebalance and to maintain contributions in tough times - the things a good adviser does - these are the things that ultimately determine investor success. We are all in the behaviour-modification business. Which types of funds we use to enact that behaviour should be a secondary concern, not the centrepiece of the debate, as it has been for far too long." From our perspective, we could not agree more with these sentiments. Let us explain why.

ACTIVELY MANAGED INVESTING VERSUS PASSIVE INVESTING

Active investing means you (or a mutual fund manager or other investment adviser) are going to use an investment approach that typically involves research such as fundamental analysis, micro- and macro-economic analysis and/or technical analysis, because you think picking investments in this way can deliver a better outcome than owning the market in its entirety.

With a passive investment approach you would buy index funds and own the entire spectrum of available securities on an index. The rationale behind a passive investment strategy is that investors believe that markets are efficient and that no mispricing exists. Meaning there is no point in seeking out mispriced assets through an active investment strategy.

Each year academic studies are conducted to compare the returns of actively managed mutual funds to the returns of passively managed mutual funds. Certain studies have shown that in the aggregate, over long periods of time, actively managed funds do not generally deliver returns higher than their passive counterparts. Some believe the reason behind this is fees - Active funds incur higher costs and the fund manager must first garner additional returns to cover the costs before the invester would begin to see performance that was higher than the comparable index fund.

However, Don Phillips the managing director with Morningstar argues the following in favour of active funds: "The math of indexing is straightforward. Lower costs ensure that over most time periods an index will better most managers' returns. A low-cost index fund generally will beat around two-thirds of its competitors and trail the other third. However, if one makes two simple adjustments in picking active managers and select only from funds with below-average costs and where managers have significant investments in their own funds, the odds improve much closer to 50/50 or even better."

These are extremely important deductions as it supports the cost aversion merits of passive investment strategies, but more importantly, it leaves room for active managers to add value, if the right managers can be identified.

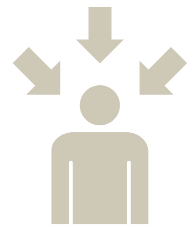
This is where the importance of financial planning decisions enters the debate.

GAMMA

The 'gamma' concept was coined by two researchers at Morningstar, David Blanchett and Paul Kaplan, in 2013. For them 'Gamma' is designed to quantify the additional value that can be achieved by an individual investor from making more intelligent financial planning decisions.

"Gamma will vary for different types of investors and for different strategies; however (in our research) we focus on five fundamental financial planning decisions/ techniques: a total wealth framework to determine the optimal asset allocation, a dynamic withdrawal strategy, incorporating guaranteed income products (i.e. annuities), tax-efficient decisions and liability-relative asset allocation optimisation."

Their research found that a retiree could expect to generate 22.6% more in certainty-equivalent income using a gamma-efficient retirement income strategy. This was compared to their base scenario, which assumed a 4% initial portfolio withdrawal where the withdrawal amount is subsequently increased by inflation and a 20% equity allocation portfolio. This addition in certainty-



equivalent income has the same impact on expected utility as an annual arithmetic return increase of +1.59% (i.e. gamma equivalent alpha). This represents a significant improvement in portfolio efficiency for a retiree. Unlike traditional alpha, which can be hard to predict and is a zero-sum game, they found that gamma (and gamma equivalent alpha) can be achieved by anyone following an efficient financial planning strategy.

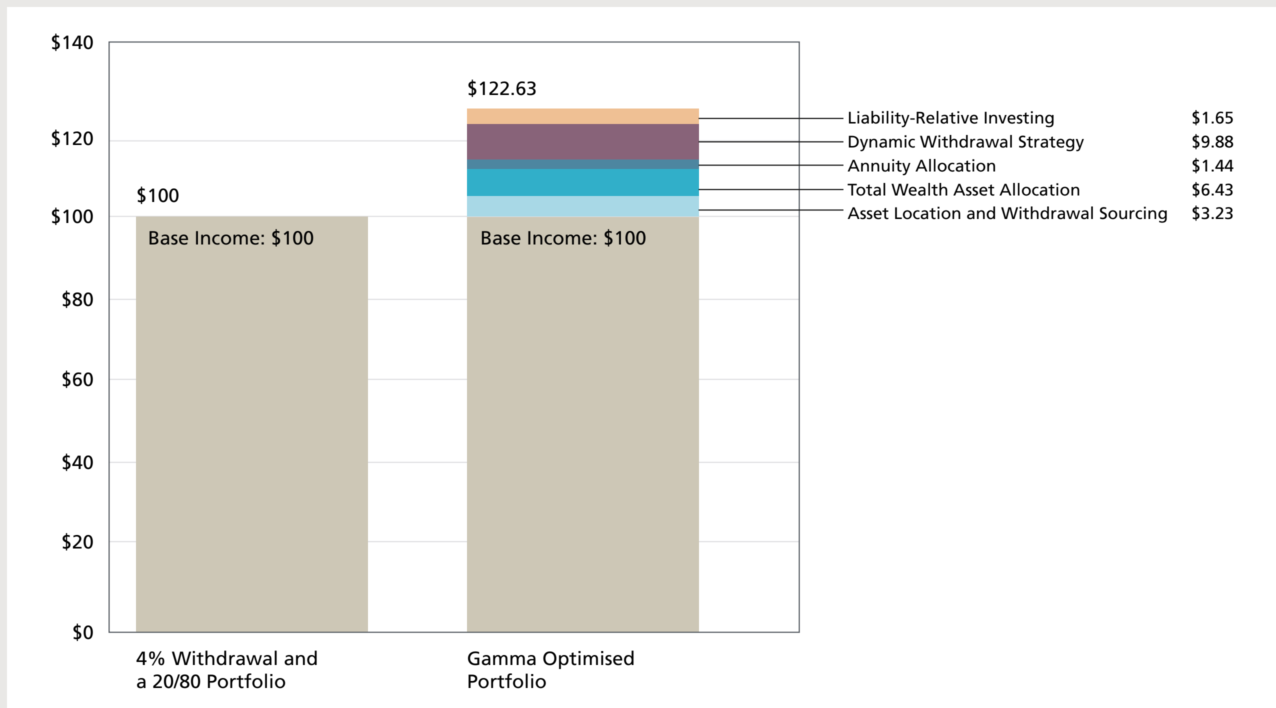
BEYOND ALPHA AND BETA

The notions of alpha and beta (in particular alpha) have long fascinated financial advisers and their clients. Alpha allows a financial adviser to demonstrate (and potentially quantify) the excess returns generated, which can help justify fees. In contrast, beta (systematic risk exposures) helps explain the risk factors of a portfolio to the market, i.e. the asset allocation.

If an adviser is paid solely to manage a portfolio of assets, and does nothing else, i.e. offers no additional advice regarding anything other than the investment of the client assets, then the concepts of alpha and beta should be relatively good measures of the value of the adviser. However, in more complex engagements, when providing financial planning services to clients, value cannot be defined in such simple returns as alpha and beta, since the objective of an individual investor is usually to achieve a goal, and that goal is most likely to achieve a comfortable retirement.

Individual investors invest to achieve goals (typically an inflation-adjusted standard of living), and therefore doing the things that help an investor achieve those goals (i.e. adding gamma) is a different type of value than can be attributed to alpha or beta alone, and is in many ways more valuable. Therefore, Blanchett and Kaplan views asset-only metrics as an incomplete means of retirement strategy performance.

Relative and combined impact of considered strategies



Source: Morningstar

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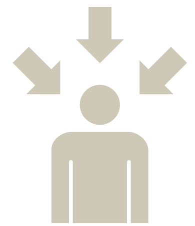
Theme spotlight

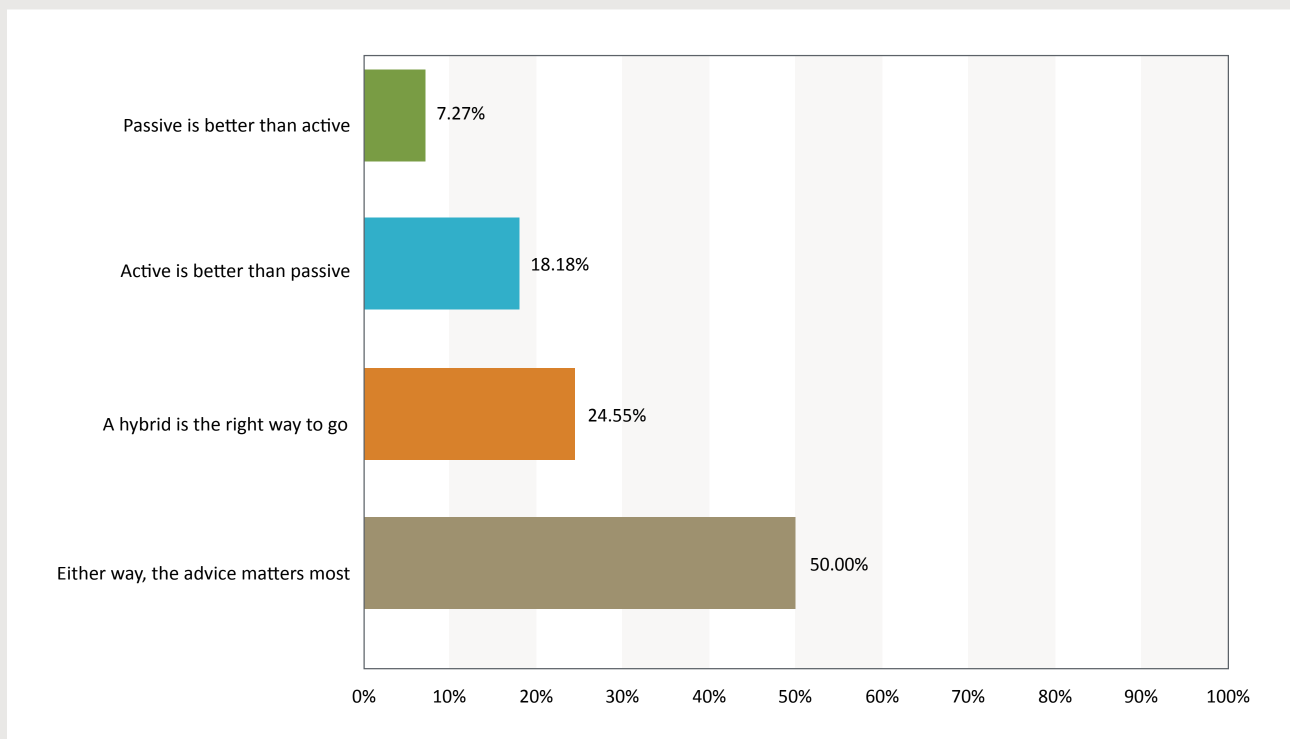


PSG WEALTH ADVISER AND CLIENT VIEW

From the above it becomes clear that no matter what strategy you follow, what matters in the end, is the quality of advice an investor receives. A survey conducted by the PSG Wealth research team showed that half of all respondents agree with this. Half of respondents feel that advice is the most important factor when it comes to choosing an investment strategy. Just over a quarter felt that a hybrid model (active and passive) is the right way to go. A small percentage (7%) of respondents felt that passive is better than active, while about 18% believe that active is better than passive.

Perhaps the point to understand is, that although beta is a proxy for passive and alpha is a proxy for active, there are more important factors to consider. Now could be the time to take the debate to the next level by not just reviewing alpha, beta and gamma, but by focussing especially on the gamma part of the equation.

WINTER SURVEY RESULTS: ACTIVE, PASSIVE OR GAMMA?

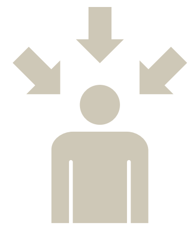


Source: PSG Wealth research team survey in the winter edition of the PSG Wealth Investment Research and Strategy Report.

Take part in our new survey on the S&P Global Ratings agency review expected in December by clicking here. The results from each quarter's question will be discussed in the next edition of the report.

PSG Wealth

Theme spotlight



THE BOTTOM LINE

Financial planning, by definition, is a goals-based profession. Financial advisers help clients determine how to accomplish their goals through advice and guidance on a variety of topics, such as saving, investing and risk management. While investing well is generally an important part of the process of accomplishing a goal, achieving a goal generally requires advice beyond building appropriate portfolios (i.e. beta) and selecting investments that are expected to outperform their peers on a risk-adjusted basis (i.e. alpha). There is a growing body of research dedicated to quantifying the potential benefits of financial planning beyond alpha and beta, like the study by Blanchette and Kaplan mentioned above.

At the end of the day, it is not just about which strategy is the best. Rather it is about which strategy is most suitable to a specific investor and the quality of advice an investor receives.

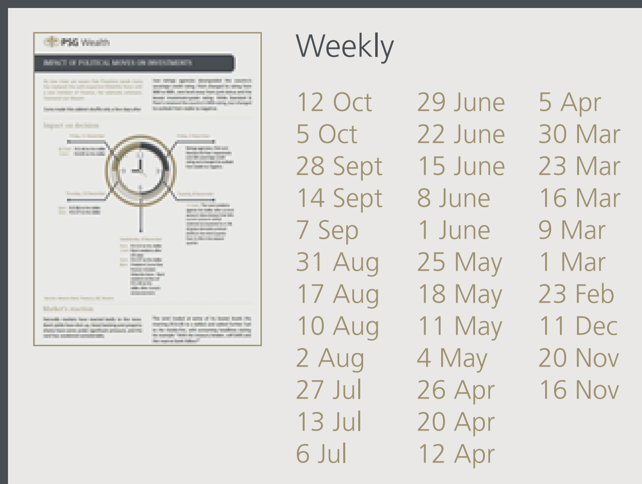
SPRING 2016 SURVEY: SOUTH AFRICA HEADING FOR JUNK STATUS?

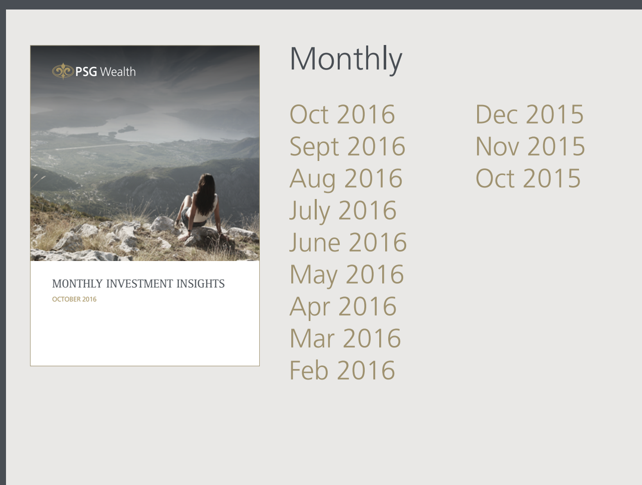
At the end of November Moody's will announce their latest credit rating of South Africa, while the S&P Global Ratings agency is scheduled to publish its next ratings review early in December. S&P affirmed South Africa's credit rating at one level above junk, with a negative outlook, in June and said the government must take decisive steps to bolster growth, quell policy uncertainty and end political interference in institutions to avoid a future downgrade.

Political tensions have increased since this last review. Reports in August that Finance Minister Pravin Gordhan was being probed by police led to a slump in the rand and bonds. In September S&P said political tension in South Africa is making economic reforms more challenging and must be watched. S&P added that while economic growth in South Africa rebounded to 3.3% in the second quarter, following a 1.2% contraction in the previous three months, it is too early to say it is setting a new trend, given the political turmoil.

Take part in our new survey by clicking here.

Previous publications





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