newsletter

Sanlam Investments

newsletter

Swaziland
4th quarter 2016

CEO's corner

2016 was a year full of surprises. In financial and political circles it will be remembered for Britain's decision to leave the European Union and the surprise election of Donald J Trump as the 45th President of the United States of America. We saw an initial global sell-off in financial markets in the wake of the Brexit referendum in June 2016. However, in the run up to the US elections, the market remained surprisingly resilient. Focus was on the seemingly positive economic aspects of a Trump victory (such as tax cuts and infrastructure spend).

We are pleased that despite the "turbulence of the unexpected", most of our portfolios have been able to deliver returns above the benchmark for the 12 month period ended 31 December 2016. In 2017, the outlook for earning growth is supportive of reasonable returns. It should however be kept in mind that the macro and geo-political landscape remains uncertain and may influence the improving fundamentals in the short term.

In this edition, apart from our normal update on our range of investment portfolios, we have included an article on why Unit Trusts are such a suitable investment vehicle. We hope that you enjoy the article. We also look forward to your continued and growing support in 2017.

Swaziland

On 24-25 November 2016 the Central Bank of Swaziland (Bank) in consultation with the Monetary Policy Consultative Committee (MPCC) held meetings to consider the appropriate monetary policy stance for the Bank.

Inflation

The Central Bank of Swaziland has observed falling inflationary pressures with the inflation rate continuing to be below the high of 8.5 per cent recorded in April 2016. Inflation was recorded at 8.3 per cent in September 2016 and further fell to 8.2 per cent in October 2016. Pressure on inflation outcomes came from high food inflation, which remained in double digits. In October, food inflation was recorded at 17.6 per cent.

Credit Risk

Further, during the two-month period to September, credit extended to private sector trended upwards slightly by 0.6 per cent. The increase in credit was driven by higher lending to local government and parastatals as well as a rise in credit to households. However, credit extended to businesses fell owing to the prevailing tough economic conditions.

Outlook

Gross Official Reserves for the country grew by 3.7 per cent over the past two months to reach E8.2 billion at the end of October 2016. The increase was mainly due to an inflow of the quarterly SACU receipts during the first week of October 2016. At that level, the Reserves covered 3.9 months of imports. As at the 17th November 2016, Reserves declined to reach E7.9 billion and were enough to cover 3.8 months of imports.

Whilst the outlook is marred by persistent effects of drought on food supply, going forward, the Bank projects that inflation outcomes will average 7.8 per cent for 2016. The recent rains point to improving conditions in the first quarter of 2017 and as such the Bank expects inflation outcomes to improve as well.

The tough economic conditions are expected to continue in the short term with growth depressed. However, the Central Bank of Swaziland has emphasized that monetary policy shall remain supportive of sustained long-term growth.

Considering the international, regional and domestic economic conditions, and pursuing its price and financial stability mandate, the Bank decided to keep the discount rate unchanged at 7.0 per cent.

Review – SA Capital Markets

The fourth quarter of 2016 was another weak quarter for SA equities, which finished the year with a total return of 2.6%, underperforming cash for the second year in a row. The low returns in 2016 were largely due to the impact of the stronger rand (12.6% appreciation in US dollar) on the dual listed heavy weights such as British American Tobacco (-9% for the year), Richemont (-14% for the year), SABMiller (-16% before it was delisted) and Naspers (+1% for the year). In contrast, mid- and small-cap shares returned 27% and 21% respectively in 2016.

The disappointing returns in the fourth quarter were in spite of South Africa managing to avoid a credit downgrade by Standard and Poor's (for now) and the positive impact that the Trump victory had on non-precious metal commodity stocks. Even if you had correctly predicted the Trump victory, global markets

reacted differently to what most would have expected. Overall, however, the impact of the Trump victory was negative for emerging markets and South Africa was no exception.

Financials (+2.9%) outperformed industrials (-4.7%) and resources (-1.2%). The best performing sectors in the fourth quarter were fixed line telecoms (+25%), industrial metals (+19%), support services (+13%) and banks (+11%). The worst performing sectors included gold (-36%), platinum (-33%), media (-15%), healthcare (-13%) and tobacco (-11%).

Review – SA Economy

Domestic economic news flow in the fourth quarter of 2016 was dominated by the ratings review of South African government debt by credit rating agencies. Moody's Investors Service (Moody's) left South Africa's government long-term bond ratings for both foreign currency and domestic currency debt unchanged in November 2016 at Baa2 with a negative outlook. This is two notches above sub-investment grade.

Concomitantly, Fitch maintained its BBB- ratings on the South African government's long-term foreign currency and local currency denominated debt. However, the outlook for the rating was also revised to negative from stable. The agency indicated it "believes that political risks to standards of governance and policy making have increased" and are likely to remain elevated until the electoral conference of the African National Congress (ANC) in December 2017. Also, the agency expressed its concern that socio-economic pressures could result in additional spending demands.

Standard and Poor's also left the sovereign's long-term foreign currency debt rating unchanged, at one notch above sub investment grade (BBB-), but downgraded the long-term domestic currency debt rating by one notch to two notches above sub-investment grade (BBB). The agency also maintained its negative outlook. S&P explained the latter action reflects its concern that South Africa's fiscal financing needs had increased beyond its previous base case expectation, while the share of rand turnover in the global foreign exchange market has also decreased over the past three years.

Outlook – SA Capital Markets

There have been only three periods going back to 1960 when equities underperformed cash for more than two successive years. The last one was in the 90's when cash beat equities 60% of the time and equities actually underperformed cash for four consecutive years. In the years in which cash beat equities it was mostly (70% of the time) when returns from equities were negative.

Looking back, the best time to invest in equities was in the year immediately after the year in which they underperformed cash. The average annual excess return from equities was 18% higher than cash in the year following equities' underperformance. This is substantially ahead of the 9.6% annual excess return from equities versus cash since 1960.

Further supporting the case for equities is the current valuation. The FTSE/JSE All Share 12-month forward Price to Earnings ratio has de-rated from almost 16x a year ago to 13x today, making equities the cheapest they have been since 2013.

Outlook – SA Economy

It is encouraging that South Africa managed to avert a downgrade on its foreign currency debt to below investment grade. So too is the progress, albeit limited, made in late 2016 towards addressing policy uncertainty and structural impediments to growth, including improved co-operation between government, labour and business. Further, expectations of some improvement in real economic activity in 2017 provide cause for optimism.

Even so, government debt consolidation requires ongoing stringent fiscal consolidation, which in the fiscal year 2017/18 is expected to include substantial revenue raising measures. The specific amounts remain to be seen, but the National Treasury did indicate in its October 2016 Medium Term Budget Policy Statement it expects revenue increases to amount to R28 billion in the fiscal year 2017/18, followed by a further R15 billion in 2018/19. Concomitantly, expenditure cuts, relative to previous projections, are expected to amount to R10 billion in 2017/18, followed by R16 billion in 2018/19. Even so government's net debt ratio is projected to increase to 47.6% of GDP by end of 2018/19, from the 46.0% of GDP recorded at end September 2016. This underlines the importance of lifting South Africa's potential economic growth rate. Failure to do so would leave the possibility of a downgrade in play.

At least, although GDP growth slowed to just 0.2% seasonally adjusted and annualised in 3Q16 from 3.5% in 2Q16, the Reserve Bank's December publication of its business cycle indicators reflects an increase in the leading business cycle indicator of 0.8% month-on-month in October 2016. The Bank notes the improvement reflects, amongst other factors, higher commodity export prices, an increase in average hours worked per factory worker in manufacturing (an improvement in productivity), better manufacturing order volumes and a steepening of the yield curve. Overall, the improved momentum in the leading indicator arrests a long slide in this index, which began in late 2013 and suggests real GDP growth should lift a bit in 2017.

Global Review – Capital Markets

During the quarter global equity markets, as measured by the MSCI World Index rose 1.86%. The positive fourth quarter means that the MSCI World index has gained a respectable 7.51% for the 2016 calendar year. The quarter's positive return was due to the strong months of November and December post the US election. Going into the election the index first declined by -1.94% in October. Once the market had digested the election result it recovered most of the losses in October by returning 1.44% in November.

The global economy did not receive any surprises in December to derail the positive sentiment and rose a further 2.39% for the month. In local currency terms the US, Eurozone, UK and Japanese equities rose during the quarter, albeit for different reasons. In the US macro-economic data improved allowing the Fed to go ahead with the hike, in Europe the ECB extended its easing program, in the UK financials led the way while resources performed well after OPEC agreed to cut oil production. Japanese equities were strong due to yen weakness in November and December.

Global Review – Economy

At the conclusion of its monetary policy meeting on 8 December 2016, the European Central Bank (ECB) indicated that it would continue with its asset purchase programme (APP) at the current pace of EUR80 billion per month until end March 2017. However, from April 2017, monthly net asset purchases will be reduced to EUR60 billion per month until end December 2017 or, if necessary, beyond that point if needed "and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim". At the same time the ECB left its policy rates unchanged, but indicated that it expects its key interest rates "to remain at present or lower levels for an extended period of time, and well past the horizon of our net asset purchases".

In Japan, the Policy Board of the Bank of Japan announced at the conclusion of its Monetary Policy Meeting on 20 December 2016 that it would continue with asset purchases at the current pace, which is an increase in its outstanding Japanese Government Bonds (JGB) holdings of around JPY80 trillion per annum in order to meet its target of maintaining the 10-year JGB yield at close to zero%.

Elsewhere, the third estimate of UK GDP resulted in an upward revision to third quarter GDP to reflect an increase of 0.6% from 0.5% previously, but left the annual growth rate unchanged at 2.2% due to downward

revisions to the first and second quarter data. Together, however, a wide UK current account deficit, reflecting a declining savings ratio, and the sharp depreciation of GBP through 2016 suggest the risk of a downward adjustment to growth is likely in 2017.

Global Outlook – Equity Markets

The unexpected outcome of the US presidential election and speculation on its likely implications dominated global financial markets in the final quarter of 2016. Since the election of Donald Trump on 8 November as the 45th US president, global investors have grappled with the consequences for the world economy, global monetary policies and global trade. Still with the US, the Federal Reserve raised the key federal funds rate target range by 0.25% to 0.5% - 0.75%. In China, economic activity was strong with industrial production higher over the quarter and manufacturing investment growth picking up. In Europe, the European Central Bank eft key policy rates unchanged in December, stating that they are set to remain at present or lower levels for an extended period of time.

In dollar terms, the MSCI World Index was 1.9% higher over the quarter while the MSCI Emerging Markets Index posted a return of -4.2%. Global bonds, as measured by the Barclays Capital Aggregate Bond Index, lost a massive -7.1% over the quarter. The rand barely moved (up 0.4%) over the quarter to end the year at R13.68 to the US dollar. For the 12 months to December, the rand strengthened 11.7% against the US dollar from the oversold levels seen post-Nenegate a year prior.

Global Outlook – Economy

Having eased monetary policy in the wake of the UK Brexit referendum the Bank of England's Monetary Policy Committee decided at its December 2016 meeting to leave the Bank Rate at 0.25%, while continuing to purchase GBP non-financial investment-grade corporate bonds of up to GBP10 billion, in addition to the GBP60 billion UK government bonds purchase programme in order to increase the total stock of these purchases to GBP435 billion.

Overall, global economic data released during the final quarter of last year suggest global real GDP growth and inflation is lifting as we begin 2017. But, there are numerous risks to the outlook, including heightened US fiscal and monetary policy uncertainty following Donald Trump's election to US President.

It is possible regulatory reform, which US President elect Donald Trump appears to favour, may remove some of the binding constraints to US GDP growth. That said deregulation is a lengthy process. Reducing and simplifying regulations could pay dividends in the long run, but one doubts it will exert a strong impact in the near term.

It must be stressed that there is a high degree of uncertainty around likely US policy changes under a Trump administration. Ultimately, some form of fiscal loosening seems likely, including tax cuts for individuals and corporates. It is uncertain, though, to what extent revenue raising measures, including "border adjustments", will claw back expected revenue losses from tax cutting initiatives. Further, proposed infrastructure spending plans are likely to take time to implement.

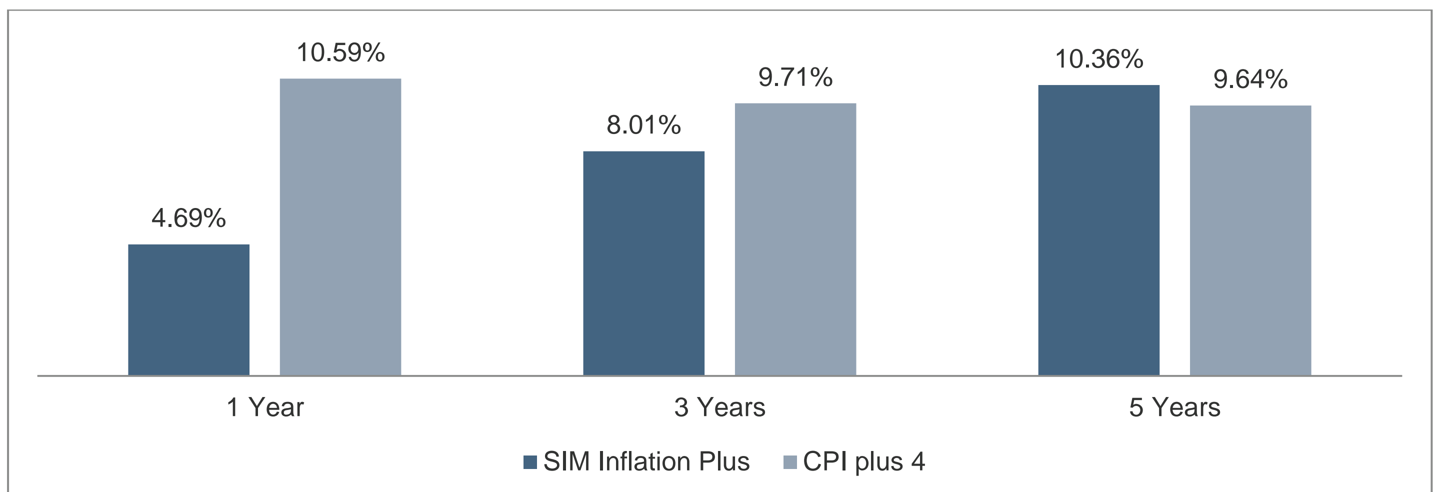
Investment Strategy

Domestic (SA)	Position	Rationale
Local equities	Underweight	We retained our underweight position. The historical price to earnings (PE) ratio of SA equities is above 20. The earnings of resources companies are expected to recover and if this materializes it should bring the PE to below 15 by year-end, which is still above our estimate of a fair PE of 12 to 13, given our long-run real required return of 7% for SA equities.
Local Bonds (SA)	Overweight	We retained our overweight in SA long bonds. They are still offering among the highest local currency real yields in emerging markets. This is particularly attractive given the low real returns available in equity and global bond markets.
Inflation-linked bonds	Overweight	We retained our overweight position. In the last quarter of 2016 the 10-year inflation-linked bond yield weakened to above 2%, an attractive real yield and on par with the long-run real return of conventional 10-year long bonds, but with considerable less risk. SA inflation-linked bonds are also attractive relative to developed market (DM) inflation-linked bonds.
SA listed Property	Neutral	We retained our neutral position in listed property for geographic diversification and its higher yield in a yield-starved environment, even though the asset class is slightly expensive at a dividend yield of 6.2%. Approximately 40% of JSE listed property companies' earnings are now from outside SA.
International (Global)	**Position**	**Rationale**
Global equities	Neutral	We retained our neutral position as real returns from competing assets were not attractive, but we are reconsidering this in the light of rising global bond yields. Global equity markets have rallied since the election of Donald Trump and the US market is currently expensive on a current rolled PE of 20 and a price to book ratio of 2.8.
Global bonds and Cash	Underweight	We retained our underweight position. At a yield of 2.4% US long bonds offer a positive real return relative to our long-run inflation assumption of 2%; but we are concerned about long-run global inflation and now require an attractive premium above 2%.
Global Property	Overweight	We retained our overweight position via listed REITs. Our portfolio currently consists of nine companies that have properties in the USA, UK, Europe and Australasia. The average dividend yield of the portfolio is 6.0%. Rising bond yields do mean the cost of funding would increase over the longer run, but we also expect some earnings growth from these companies.

Fund Performance

SIM Inflation Plus Fund

This is a multi-asset low equity fund which aims to deliver smooth, positive real returns (adjusted for the effects of inflation) targeting CPI +4% over a rolling 3 year period. Equity exposure is limited to 40%. This actively managed fund is a combination of investments in equity, bonds, money market instruments and listed property both locally and abroad. It can invest 25% offshore. This fund uses derivatives to protect capital.



Fund Commentary

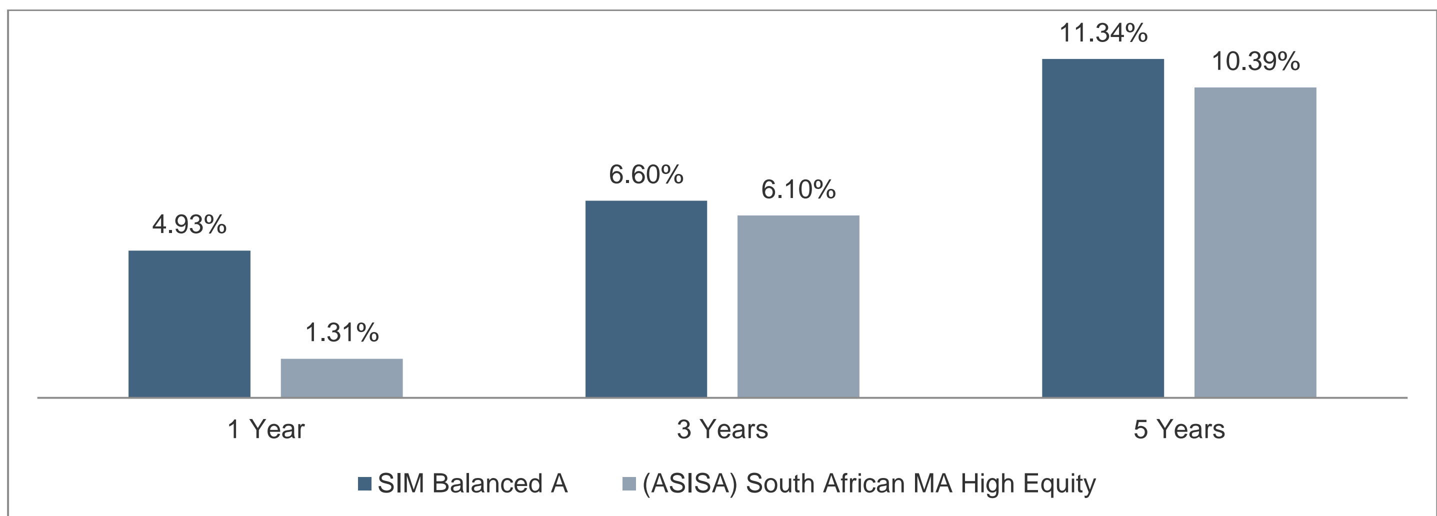
Over the quarter the overall fund duration stayed fairly constant with little changes between the different fixed-income asset classes. We continued the process of yield enhancement although corporate credit looks expensive relative to bank credit spreads. Our clear preference for fixed-rate negotiable certificates of deposit (NCDs) and nominal bonds over inflation-linked bonds paid dividends over the calendar year, although, admittedly, we started 2016 at very attractive nominal yield levels.

The overall strategy of maintaining downside protection for the domestic equity component of the Absolute Return funds worked well in 2016. The funds' domestic equity exposure increased over the quarter due to the rolling of some protective overlays. We reduced our international equity exposure somewhat as global equities are starting to look expensive, especially the US component. The lack of other attractively valued offshore investments prevented us from implementing a more aggressive view. For funds with international exposure, the maturities of currency hedges led to an increase in offshore exposure. This strategy worked well as we saw the rand strengthening over the course of the year.

As stated last quarter, South African fixed-income assets remain attractive as an investment case, despite very good 2016 performances. Real yields of between 2% and 3% are still on offer in the fixed-income space. Although breakeven inflation levels have come down from the first quarter levels, we still prefer nominal bonds over inflation-linked bonds over the medium term. Some of the possible headwinds for the local fixed-income market could be rising global inflation expectations, rising global bond yields and currency weakness from unexpected political surprises.

SIM Balanced Fund

This is a medium-risk portfolio that aims to deliver income and capital growth over the medium term. This portfolio is designed to minimise volatility and aims to cultivate as smooth a ride as possible. There is some exposure to risky asset classes (such as equities) necessary to grow capital over the medium to long term. This fund holds a large weighting in JSE shares with a maximum equity exposure of 75%. Capital exposure will also include investments in money market instruments, bonds, listed property and up to 25% in offshore assets. The preservation of real capital is of primary importance in achieving this objective.



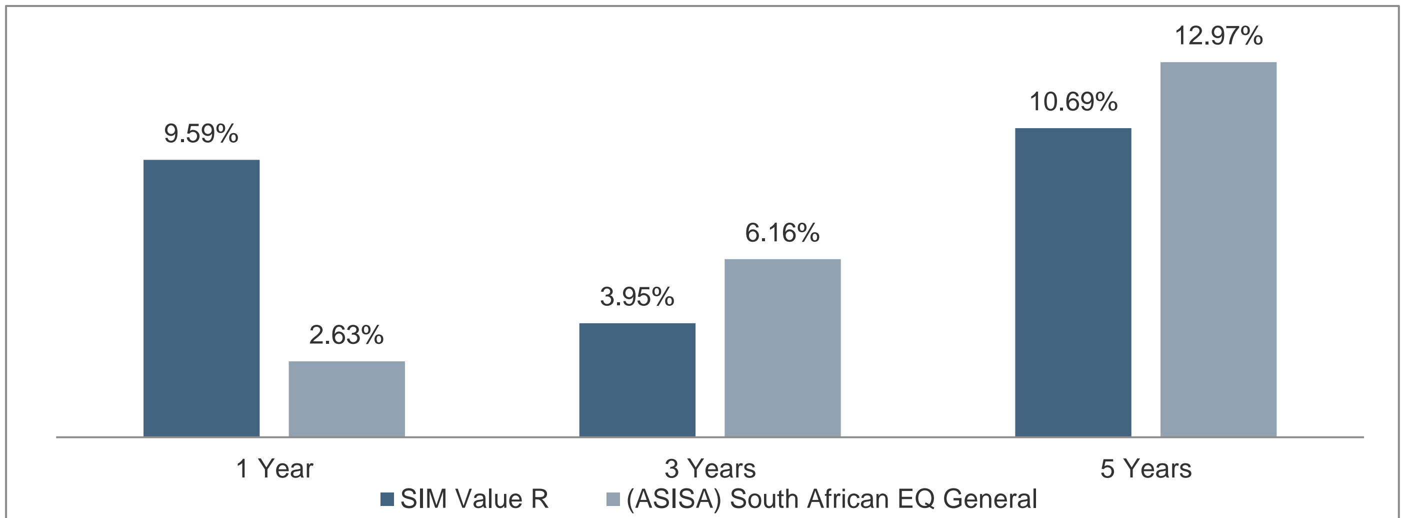
Fund Commentary

During 2016, global political uncertainty rose considerably. In Europe, the Brexit vote and the Italian referendum caused uncertainty with respect to the future of the European Union (EU) and Britain's role within the EU. The election of Donald Trump as the US president has further increased uncertainty due to his proposed policies, some of which are impractical or ambiguous.

It is considerably easier to determine asset prices in an environment of political and economic stability. The value of assets depends on the future cash flows that they can generate, discounted by the time value of those cash flows - the risk-free rate. The future cash flows of companies, for example, are more uncertain in a political environment that is rapidly changing. Typically, we would require a higher risk premium or discount when buying assets to compensate for the increased risk. This is not something we are seeing in the pricing of international assets. Instead, they have become more expensive.

SIM Value Fund

This is an aggressively managed pure equity fund diversified across all sectors of the JSE. It offers a reasonable level of current income and the potential for long term outperformance. The portfolio aims to deliver capital growth over the long term (greater than 5 years) also substantially outperform the markets. The portfolio is diversified across all major asset classes with significant exposure to equities, and may include offshore equities. The fund managers only invest in shares which are undervalued and are very aware of downside risks. A maximum of 25% offshore assets may be held. There may be some capital volatility in the short term, although higher returns may be expected from five years or beyond.



Fund Commentary

Our continued focus on identifying mispriced opportunities and having the courage of our convictions to sometimes go against the crowd paid off for our clients in 2016. In spite of the market showing negative returns, our clients' portfolios showed positive returns in the fourth quarter and significantly outperformed their respective benchmarks. Big contributors to these positive returns came from our investments in Barloworld (+42%), Altron (+42%), Anglo American (+13.8%), Investec (10.8%) and Hudaco (+11%).

Stocks which detracted from performance in the fourth quarter included our investments in Northam (-22%), Group Five (-11%), Reinet (-10%), Shoprite (-11%) and Steinhoff (-7%).

The benchmark-agnostic and diversified approach we take in allocating capital meant the portfolios were better able to withstand the several surprises and shocks during the year. In addition, the number of mispriced opportunities in the mid and small-cap space provided a source of differentiated returns compared to some of our peers. On a net basis our investments in smaller-cap companies contributed about 20% of the excess returns for the year.

The outperformance we achieved this year was based on a very conservative investment approach. Our portfolios did not have excessive concentration in any one sector or stock. In particular, our overall position in resources was not materially higher than the market and well below many of our competitors. However, the stocks which we were invested in like Anglo American (+182%) and Northam (+54%) performed substantially better than the Resources Index (+34.2%).

Unit trust 1.0

U Is For Unit Trusts = A Diversified Portfolio

Unit trusts give access to a diversified portfolio by pooling investors' money.

A unit trust is a popular choice for investors who want access to blue chip shares and bonds, which are not cost-effectively available to direct investors with relatively small amounts to invest. In essence, a unit trust fund is a portfolio of investments that has been divided into units. Each unit is valued daily, based on the value of the underlying investment portfolio. Depending on the type of unit trust fund, the portfolio could consist of shares, property, bonds and other fixed income assets – both locally and offshore. With the exception of a money market fund, the value of the units goes up and down as the value of the underlying portfolio fluctuates.

Unit trusts offer various benefits to investors

- ***Professionals manage your investments on your behalf***

These professionals have a wealth of investment expertise and experience. You don't have to make any difficult investment decisions or monitor the asset composition of your portfolio. This will be done for you.

- ***Risks are minimised with adequate diversification***

The fund manager will diversify your investments across the different asset classes, such as equities, bonds and cash. This protects your portfolio from being too exposed to potential declines in the value of a single share or asset class as performance is spread across a variety of underlying investments.

- ***Unit trusts are one of the most affordable ways of investing***

You can invest in the unit trust of your choice from as little as R200 a month or a lump sum of R5 000.

- ***Unit trusts have no lock-ins and you can add money or switch at any time***

You can buy and sell units as you choose. But think carefully before you jump between unit trusts, as research shows that investors that switch often receive a significantly lower long-term return on their initial capital than investors who remain in the same fund across their investment period. Remember that no one manager outperforms his peers year after year. All unit trusts have periods of underperformance relative to other unit trusts in the same sector.

- ***Your money is safe in a unit trust***

By law, the fund manager has to invest the money in accordance with a signed investment mandate. You are therefore protected from rogue or irresponsible traders. Your money is largely invested in liquid, publicly-listed investments, with regulations allowing a maximum of 10% to be invested in unlisted investments. Your money is held in trust for you, so even if the unit trust closes down, your money is safe.

Unit trusts are a medium- to long-term investment, so give your money time to grow

With the exception of a money market investment, it is possible for the value of your investment to be worth less over the short term than the money you initially invested. This does not mean you should sell any or all your units at such times. To be able to outperform cash in the long run, you need to take on the volatility that accompanies the other asset classes. No risk, no better-than-cash return. Therefore give your money the time it needs to grow.