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Sanlam

Investments

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Swaziland
4th Quarter 2015

CEO's Corner

As we come to the end of 2015, it is good to be able to review the last quarter of 2015wwhich was filled with so much global turbulence. Please see below Sanlam's quarter reviews at a glance. We wish you all a 2016 filled with lots of peace, growth and happiness.

Q4

6 OCT
SA Business confidence falls to 22-year low.
Source: *SACCI*

13 OCT
AB InBev agrees to buy SABMiller for R1.4 trillion.
Source: *Bloomberg News*

19 OCT
China GDP grows by 6.9%, the worst since 2009.
Source: *Reuters*

27 OCT
SA unemployment rises to 25.5%
Source: *Statistics SA*

10 NOV
Rand falls to its weakest level ever against the US dollar.
Source: *Fin24*

19 NOV
The Reserve Bank hikes the repo rate due to drought, the rand and electricity costs stoking inflation. Source: *Moneyweb*

24 NOV
Q3 GDP grows by a mere 0.7% annualised, dragged down by agriculture and mining.
Source: *Statistics SA*

08 DEC
UK household spending rises to its highest since the GFC but remains below pre-crisis levels.
Source: *Reuters*

09 DEC
Rand weakens to record low against the dollar after president Zuma dismisses finance minister Nene.
Source: *Reuters*

crisis

13 DEC
In another surprise move, president Zuma replaces finance minister Van Rooyen with stalwart Pravin Gordhan.
Source: *Mail & Guardian*

16 DEC
The Fed ends 7 years of near-zero interest rates with a modest 25bps hike.
Source: *Fortune.com*

Q4

21 DEC
Brent Oil slides to $36 a barrel – an 11-year low.
Source: *Bloomberg Newsa*

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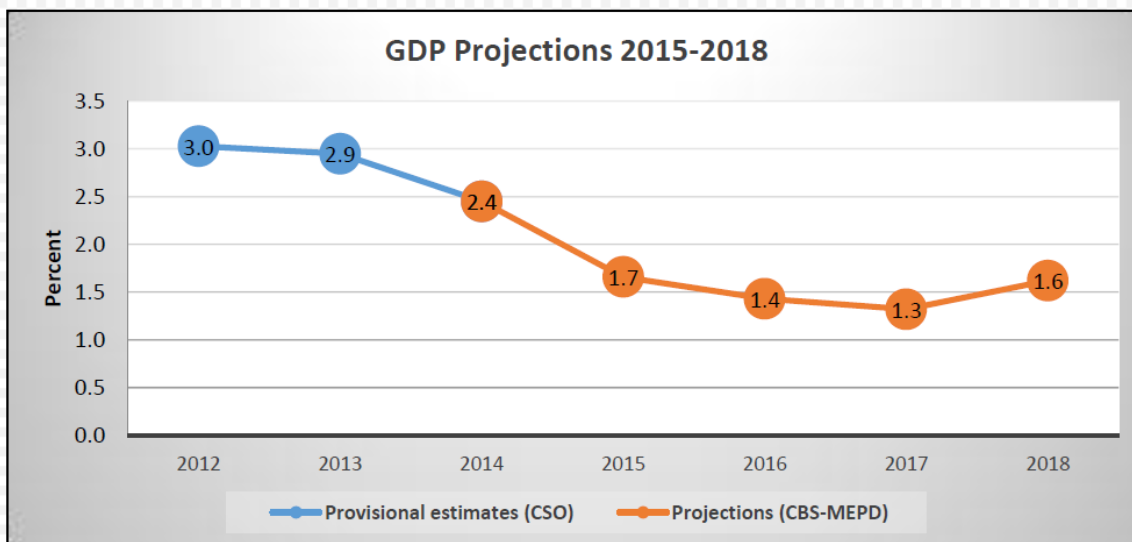
Swaziland Economic and Market Review

According to Central Bank report for December 2015, real GDP slowed from 2.9% in 2013 to 2.4 in 2014. The decrease in GDP growth mainly resulted from poor performance in the primary sector and loss of momentum in the tertiary sector. The report goes on to state that growth is expected to decline in the medium term as illustrated in the graph below.



Source – Central Statistics Office (CSO)

Consumer inflation increased to 4.9% in December 2015 from 4.5% in November 2015. In terms of monetary policy and money supply, the discount and prime rates stood at 5.75 percent and 9.25 percent respectively in December 2015. Private Sector credit reflected a marginal decrease of 0.4 percent (m/m) to settle at E11.4 billion in November 2015 with broad money supply (M2) improving slightly by 0.2 percent (m/m) to reach E12.7 billion in November 2015.

On the fiscal side, the Central Bank reports that gross official reserves stood at E8.5 billion reflecting a contraction of 4.5 percent (m/m) in December 2015. Total public debt at the end of November 2015 was recorded at E7.44 billion, indicating a marginal increase of 1.20 percent from E7.35 billion recorded in November 2015. Overall balance of payments slipped from an overall surplus of E82.8 million in the first quarter of 2015 to a deficit of E290.9 million in the quarter ended June 2015.

Within the capital markets, commercial banks still dominate participation in the Treasury bill and bond market followed by non-banked financial services, accounting for 49.81 and 42.72 percent respectively. At the end of December 2015, the Central Bank reports that preliminary debt figures indicate that public debt stood at E7.44 billion indicating a marginal increase of 1.2 percent from E7.35 billion recorded in November 2015. The increase was due to the continuing deterioration of the Lilangeni against major foreign currencies in which government liabilities are dominated. Notably, the government debt ratio at 14.4% of GDP, is well within the internationally accepted level of 60% of GDP.

Review – SA Capital Markets

2015 was filled with numerous challenges for investors in South African equities. The FTSE/JSE All Share Index managed a positive return of 5.1% (total return including dividends) in local currency and while this return was below cash returns of 6.5%, it was substantially better than bonds' -3.9% for the year. Unfortunately the return in USD was a staggering -21.4%, significantly underperforming the average emerging market return of -15%. Emerging markets continued to underperform developed markets in 2015 due to tightening monetary policy, weaker commodity prices, slowing GDP growth and a stronger US dollar. Factors which weighed heavily on South African equity returns in 2015 include lower commodity prices, credit rating downgrades, rising long bond rates (resulting in a higher cost of equity or discount rate for risky assets) and slow progress on structural reforms.

Jacob Zuma's replacement in December of highly regarded finance minister Nene with an unproven new minister (David Van Rooyen) did not help. The bond market also reacted sharply to the negative news with the benchmark 10-year yield rising 130bp over the 4th quarter. Rand hedges were the major winners in 2015, with sectors like Paper (+64%), Beverages (+57%), Tobacco (+44%), Media (+40%) and Household Goods (+34.8%) benefitting from the 35% devaluation of the rand versus the US dollar. Those sectors which struggled included Industrial Metals (-77%), Platinum (-62%) and Construction (-41%), which suffered from a combination of lower commodity prices and a fall in investor confidence. SA banks were not left unscathed and were down 13% for the year, due to the slowing economy and concerns around further credit rating downgrades.

Review – SA Economy

Against the background of depressed terms of trade and poor productivity outcomes, the South African economy is in a downswing and is experiencing its slowest income growth since the past recession. GDP advanced just 4.5% in the year to end 3Q15 in current prices (while real GDP was just 1% stronger than a year earlier). Soft real income growth, an increasing tax burden and higher debt servicing costs are constraining final consumption expenditure by households. Further, private sector fixed investment spending and employment growth have stalled, given depressed business confidence (at its lowest level in two decades), lower corporate profitability and poor returns on fixed investment spending. Accordingly, real GDP growth is expected to remain weak and may record no growth in 2016, following an estimated increase of just 1.25% in 2015.

Outlook – SA Capital Market

In an environment of ongoing global macro uncertainties combined with the unfolding of SA-specific issues, investors are continuing to pay up for quality businesses with international exposure and low financial/operating gearing. This is evident in a small, concentrated number of shares trading at high PE ratios and supporting the overall market price level. South African equities continue to trade at a substantial premium to other emerging markets on both a price to earnings and a price to book basis. Even though local equities are about 10% cheap using a bottom up valuation of the individual companies, we continue to prefer global developed market equities. Given current market conditions we believe the risk of capital loss remains, necessitating a continued cautious and disciplined approach to investing.

Outlook – SA Economy

South Africa will continue to face substantial challenges in the year ahead, but this is not the first time we as a country have had to navigate extremely challenging conditions. A lot of businessmen and women we have spoken to are extremely pessimistic about the short-term prospects and while corporate earnings will be under short-term pressure, we are doing substantially better than some of our emerging market peers. With corporate growth under pressure, it does however make it more difficult to understand the total sum of the market's reaction to the challenges that lie ahead. The biggest question on everyone's mind is whether there will be a further credit rating downgrade to "junk" status. Much will depend on the successful execution of the interventions required to improve South Africa's budgeted deficit and debt to GDP ratio. These include the possible sale of state assets like SAA, cutting government expenditure, and a serious fight against corruption and the well-crafted patronage system. If South Africa does not fix these problems, the trends experienced at the end of last year will likely just be the beginning and we will continue to see further capital flight, increasing unemployment and a weaker rand. Additional rate hikes by the SARB are certainly on the cards for 2016, which will no doubt exert further pressure on an already disheartened consumer. A modest GDP growth rate of 1% is expected for 2016.

Global Review – Capital Markets

The final quarter of 2015 saw the MSCI World Index post a dollar return of +5.1%, compared with a small gain of 0.7% for MSCI Emerging Markets. 2015 proved to be a tough year for both emerging and developed markets, down 14.6% and 1.8% respectively. Global bonds, as measured by the Barclays Capital Aggregate Bond Index, fell 0.9% for the three months to end December. In currency markets the US dollar remained strong against all global currencies and the rand sold off massively to close the year at R15.49/US$ from R11.57/US$ just 12 months earlier. Within global equities, we continue to favour Europe and the UK to the rest of the developed world on relative valuation grounds. Our international property holding at an average dividend yield of close to 5.5% is attractively valued versus offshore cash and bonds.

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Global Review – Economy

Among developed economies, US economic growth continues along a moderate path, while a mild recovery continues in the Euro area. In the former, consumption growth is relatively firm, underpinned by relatively buoyant employment growth. But, for the most part, downward revisions to growth expectations over the past year have been focused on emerging market (EM) economies where falling terms of trade (lower export commodity prices), softer productivity growth, weaker corporate profitability, geopolitical tension and stubbornly high inflation, in some cases, have taken their toll.

The US Federal Reserve raised interest rates by 25bp in December 2-15 (the first interest rate increase since 2006) while the accompanying FOMC which made reference to "gradual" increase in rates going forward gave investors some comfort. The Fed always indicated that when unemployment falls to 5% they would begin to raise rates, and they did not disappoint. The strong non-farm payrolls and fall in initial job claims saw unemployment falling to 5%, the lowest level since 2008. At the same time that the Fed has taken further steps to tighten policy, the Bank of Japan and European Central Bank (ECB) remain in a very accommodative stance with the ECB further cutting the deposit rate in December 2015 to -0.3% to help boost still-low inflation. In China, the uncertainty about the outlook for the renminbi and the effectiveness of policymakers led to large capital outflows. Concerns about Chinese growth took centre stage as economic activity data continued to disappoint.

Global Outlook – Economy

In contrast, the US Federal Reserve, which concluded its asset purchase programme in October 2014, is shifting towards a less accommodative monetary policy stance. The US Federal Reserve's message is straightforward. Its Federal Open Market Committee (FOMC) argues a falling unemployment rate may lift wages and ultimately inflation. The point is debatable, but continued firm non-farm payrolls data and a projected increase in inflation to 2% over the medium term contributed to the decision of the FOMC to increase the target range for the federal funds rate from ¼ to ½% at the conclusion of its monetary policy meeting on 16 December 2015 (from the previous range of 0 to 1/4%). At the same time, the FOMC did indicate that further increases in the federal funds rate are likely to be implemented at a gradual rate, while also expecting the federal funds rate to remain below its expected long-term level "for some time".

Global Outlook – Equity Markets

Developed market risky assets and particularly equity markets are expensive relative to their own long-run history. The US market is trading at 26 times its inflation-adjusted average 10-year earnings (the Graham and Dodd PE) relative to its long-run average of 16.5. We believe the overvaluation is, to some extent, justified due to the fact that global risk-free assets, US government debt, are trading at extremely low real yields. These low real yields are partly due to central bank and government policies that are being followed in the wake of the 2007 financial crisis. It is also useful to consider the relative valuation of various other asset classes. US and European corporate bond spreads have weakened over the past few months. US high yield bond spreads weakened by 2% and US BBB bonds weakened by 1%. Furthermore, emerging market equities have re-priced. On a price to book basis the discount at which emerging markets now trade relative to developed markets has not been this large since 2001. As the risk premium that investors require from the developed credit markets and emerging equity markets has risen, it does make developed market equities relatively less attractive.

We continue to prefer Europe and the UK to the rest of the developed world. As we reduced our exposure to MSCI World Equities, the bulk of our reduction will be from US equities as they make up almost 60% of the MSCI World Index.

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Investment Strategy

4th quarter 2015

Domestic (SA)	Position	Rationale
Local equities	Underweight	We retained our underweight position. Emerging markets (EMs) de-rated in 2015, but SA equities continue to trade at a substantial premium to other emerging markets on both a price to earnings (PE) and a price to book (PB) basis. Even though SA equities are about 10% cheap using a bottom-up valuation of the individual companies, we prefer global developed market (DM) equities.
Local Bonds (SA)	Overweight	We retained our overweight position. Ten-year bonds weakened from 8.5% to 9.5% during the quarter. We are of the opinion that inflation remains contained within the target range. The current real return of approximately 4.0% is attractive relative to other asset classes. In addition, the rand trades at very weak levels on a purchasing power parity basis. If it appreciates, the resultant lower short-term inflation should be positive for SA bonds.
Inflation-linked bonds	Overweight	When we implemented the overweight position in December we were concerned about government overspending and inefficiency, which would have severe negative implications for future inflation. We believe that for a rand investor the best protection against unexpected future inflation is inflation-linked bonds. We consider the default risk to be low as the government is in control of the rand printing presses. In December ten-year inflation-linked bonds traded at real yields of 2.3%. These bonds have now strengthened to 1.85%. Our current long-run assumption of fair value is 1.5%.
SA listed Property	Neutral	We retained our neutral holding in listed property, even though dividend yields have weakened about 0.7% from their best levels. We prefer international listed property companies, which we believe are cheaper.

International (Global)	Position	Rationale
Global equities	Overweight	We reduced the size of our overweight exposure to global equities, as DM risky assets, particularly equities, are now expensive relative to their own long-run history. The US market is trading at 26 times its inflation-adjusted average 10-year earnings (the Graham and Dodd PE) relative to its long-run average of 16.5. We believe the overvaluation is, to some extent, justified as global risk-free assets are trading at extremely low real yields, partly due to the policies followed since the 2007 financial crisis. Furthermore, EM equities have re-priced. On a PB basis the discount at which EMs now trade relative to DMs has never been as large since 2001. We continue to prefer Europe and the UK to the rest of the developed world. As we reduced our exposure to MSCI World Equities, the bulk of our reduction will be from US equities as they make up almost 60% of the MSCI World Index.
Global bonds	Underweight	The real yield on offer from DM bonds remains unattractive relative to more risky assets. We retained our underweight position in favour of international listed property.
Global Property	Overweight	We retained our overweight position via listed REITs. Our portfolio currently consists of nine companies that have properties in the USA, Europe and Australasia. The average dividend yield of the portfolio is 5.5%.

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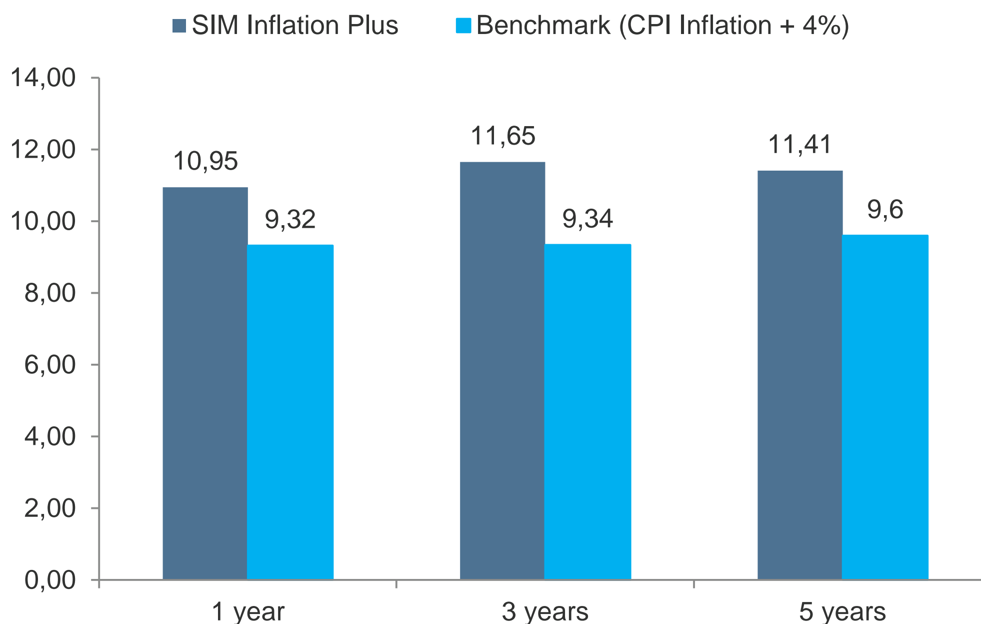
Fund Performance

4th quarter 2015

SIM Inflation Plus Fund

This is a multi-asset medium 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 60%. This actively managed fund is a combination of investments in equity, bonds, money market instruments and listed property both locally and abroad. It invests 25% offshore and uses derivatives to protect capital. The fund has performed well compared to its benchmark (CPI +4%).

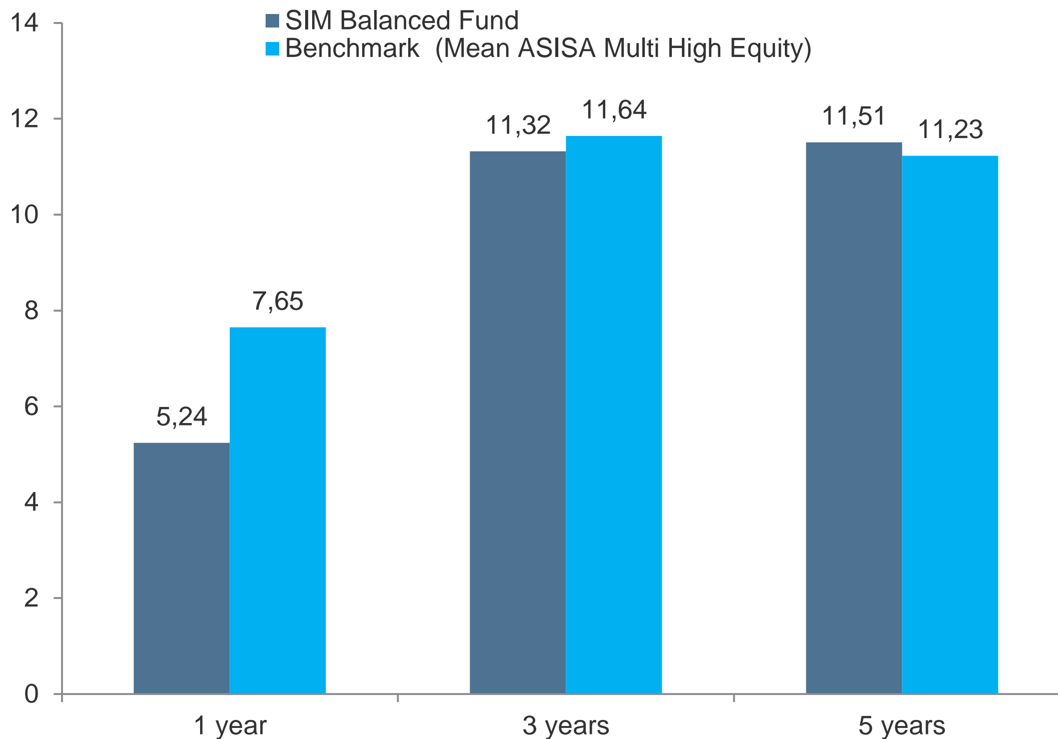


Fund Commentary

Domestic fixed income assets have re-rated during the last quarter of 2015. Our view is that this is a longer-term buying opportunity, although we acknowledge that the risk premia for South African assets have increased. The real return on offer from nominal bonds is between 3% and 4%, which is attractive relative to other asset classes. The fund's fixed income component is yielding well over 8% and bodes well for income seeking investors. We're maintaining our downside protection for domestic equities. The challenge is to make sure we allow for enough upside participation for the fund. Although domestic equities are starting to show value from a bottom-up perspective, it is still expensive versus emerging market peers. We still prefer offshore equities to their domestic counterparts, but the valuation gap has closed more recently. International property stocks are preferred to developed market bonds while we have also retained our overweight European equity position.
Despite the volatility and poor economic outlook for South Africa, we stick to our philosophy of favouring stocks that trade at reasonable valuations, while making sure that risk is well managed.

SIM Balanced Fund

The Balanced Fund holds a variety of instruments and will primarily be equity centric, seeking long term capital growth. Currently the manager has a strong preference for offshore assets and has an exposure of 25%. The Balanced Fund performs very well compared to the category average and produces handsome risk adjusted returns. The Balanced Fund generated competitive returns and has beaten its benchmark over the longer term (5 years plus).



Fund Commentary

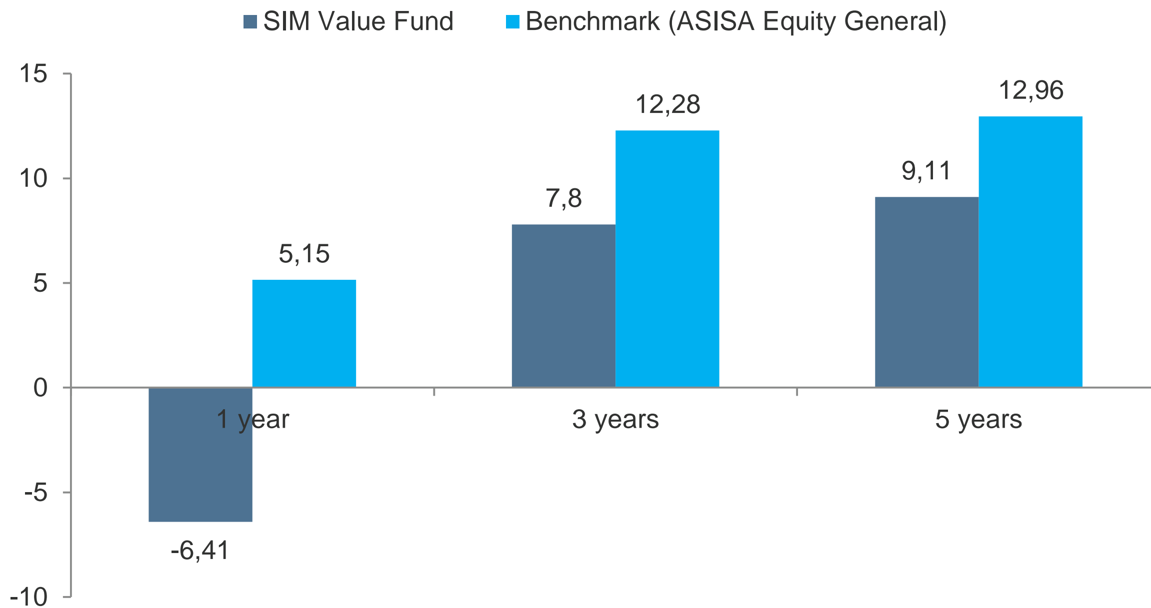
In December the risk premier attached to South African assets increased significantly after the surprise dismissal of the Minister of Finance by the President. The yield of South African USD 10-year sovereign bonds weakened by approximately 0.6% after the announcement, which is a reflection of the increase in the sovereign risk of the country. Local 10-year bonds weakened by approximately 2% to 10.4%, offering a real return of 4.5% above the upper end of the inflation target. This reflected an increase in the inflation risk premium of South Africa. The equity risk premium for companies who derive their income from the South African economy did also increase substantially. The subsequent appointment of Minister Pravin Gordhan as the new Finance Minister should give some confidence that the government does heed the financial markets. In all likelihood, these events have strengthened the hand of National Treasury to continue with its fiscally prudent policy.

There is also the risk that the credit rating of South Africa can be downgraded to sub investment grade. We are of the opinion that the risk of this is to some extend already priced into South African assets.

SIM Value Fund

This is a 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 fund manager only invests in shares which are undervalued relative to intrinsic value and are very aware of downside risks. A maximum of 25% offshore assets may be held.

This fund may invest in any listed share, but focuses on financially sound companies which offer exceptional value. These include shares with a low price to earnings ratio; shares trading at a discount to their net asset value and shares whose price does not yet reflect future earnings potential. The fund is suitable for clients seeking long term capital growth and an unconstrained investment style.



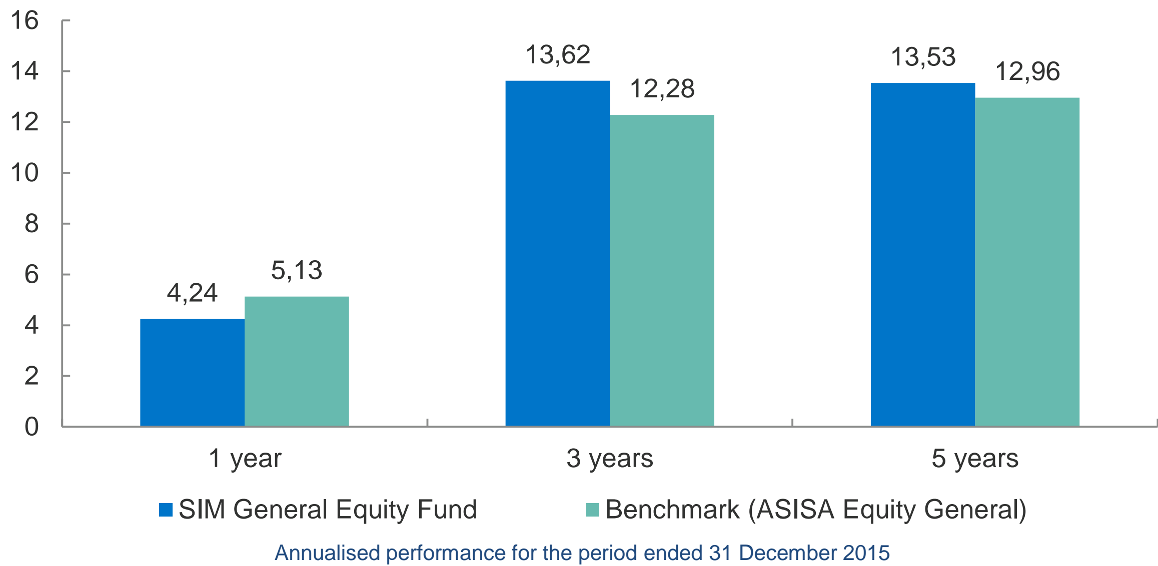
Fund Performance Commentary

Unfortunately value stocks continued to remain out of favour in 2015 and cheap stocks continued to get cheaper during the year. During 2015, the MSCI Value Index for South Africa returned negative 14.5% versus the MSCI Growth Index which was flat. The last quarter was particularly bad with the MSCI Value Index falling 10.3% vs the MSCI Growth Index returning a positive 7.4%. This was largely due to the strong performance from expensive rand hedge stocks relative to cheaper Resources and South African Industrial shares as described above. In addition, mid and small cap shares (mostly domestic businesses by nature) returned -7.5% and -3.9% respectively for the year versus 7.5% for large cap shares. This made it particularly difficult for active stock pickers, with a preference for investing in cheaper mispriced stocks to outperform the market. In 2015, only 37.8% of general equity managers managed to outperform the FTSE/JSE All Share Index. This is substantially worse than what was witnessed in the prior year (49.6%) and in 2013 (45.7%).

While we do not have control over the outcome of markets, we are confident that, by sticking to our time-tested investment approach and maintaining a laser like focus on our investment process, investors will in time be handsomely rewarded.

SIM General Equity Fund

This is a pure equity fund diversified across all sectors of the JSE. This fund is suitable for investors who can withstand potential capital volatility in the shorter term. This fund aims to outperform the FTSE/JSE All Share Index through active stock selection across all sectors and market capitalisation on the JSE. The fund aims to achieve maximum capital growth over the medium to long-term by investing in companies that are undervalued relative to realistic growth prospects. The fund is not suitable for the short term investor.



Annualised performance for the period ended 31 December 2015

Thank You

The team at SIM Swaziland would like to thank all of our investors for a successful 2015. We value you!