GLOBAL BRIEF

Quarter 1 | 2017

Editorial comment

John Swart | CEO | FIRSTGLOBAL Asset Management

Just as we thought the ship was sailing into calmer waters with investors' confidence levels rising and a Rand heading towards R12 / US Dollar, President Jacob Zuma dropped a bombshell shortly after midnight on the 31st of March by announcing the biggest cabinet reshuffle since he assumed office in 2009. This reshuffle saw Finance Minister, Pravin Gordhan and Deputy Finance Minister, Mcebisi Jonas lose their jobs and even more questionable Zuma loyalists taking control of ministries desperately in need of better direction.

Just as the news sank in, S&P Global Ratings announced its decision to lower South Africa's long-term foreign currency sovereign credit rating to 'BB+' from 'BBB-'.

All of this has ensured that our local equity markets and currency are under tremendous pressure, characterised by extreme volatility. While these events literally took place just after quarter end, their significance and possible consequences warrant discussion as it is all so relevant now.

The selection of articles, all written by academics and practitioners in the field, are bound to shed some light in this dark tunnel while the importance of staying invested in times of market uncertainty is re-emphasized.

For those who have read part one of Retirement Funding for Private Individuals, please do not miss part two, which appears at the end of this newsletter.

Regards

John Swart

An April Fool's Tale

Patrice Rassou | Head: Equities & Mokgatla Madisha | Head: Fixed Interest
Sanlam Investment Management

The murky world of political intrigue has certainly taken centre stage with the surprise removal of Finance Minister Nene at the end of 2015, which gave our financial markets a shock jolt, only to be revived by a spectacular volte-face and the appointment of a more experienced Pravin Gordhan, and yet another abrupt about-turn with Gordhan's removal on the eve of 30 March. This was followed hot on the heals by the S&P's downgrading of SA to junk status. Politics has undoubtedly been the dominant theme driving global financial markets in the past year.

Junk status: what it means

S&P's lowering of South Africa's credit rating to junk status sent the rand plummeting even further following the surprise Cabinet Reshuffle. South African banks lost R60-billion in the initial hours following President Jacob Zuma's Cabinet reshuffle. But that is nothing compared to what the country still stands to lose if the government does not respond appropriately to rating agency Standard & Poor's (S&P's) decision to downgrade South Africa to junk status.

It is expected that newly-deployed Finance Minister Malusi Gigaba will band together with former Finance Minister Pravin Gordhan to explain the situation to the global investor community. Our policy response is more critical than ever, says Mokgatla Madisha, head of Fixed Interest at Sanlam Investment Management.

What have been the impact of recent announcements on the markets?

A weaker rand is not necessarily inflationary

The rand has lost about 10% since Minister Gordhan was recalled from his oversees trip and bond yields have risen about 90bps. A 10% weakening of the rand, if sustained, will result in inflation going up by about 0.70%. However, at current levels of about R13.90/USD the rand is still 5% stronger than last year's average level of R14.70/USD. The current level of the rand is therefore not inflationary.

Bond markets have priced in the downgrade

The 90bps increase in yields over the last week has reduced bond portfolio values by about 6.6%. We have seen very little trading in corporate bonds but a number of auctions were postponed as a result of the volatility of the last week. We expect even more pressure on SOE spreads and possibly on bank bonds too.

A rating downgrade usually drives more selling as bonds no longer fall within mandates. South Africa is still rated investment grade (IG) on its local currency debt and our view is that we are not likely to see much more selling as a result of the S&P announcement. South Africa's five-year dollar credit default swap (CDS) was already priced at the same level as Brazil, which is rated BB, around 225bps. Furthermore, Russia and Croatia, which are rated BB, are trading at 167bps and 181bps respectively. On a relative basis SA debt has been priced for the downgrade.

The negative outlook is worrying

S&P retained a negative outlook on the rating, suggesting that they see scope for further action if there are no corrective actions taken. How policymakers respond to the downgrade is going to be crucial. If South Africa is to regain investment grade status, tough decisions are needed. Faster fiscal consolidation is imperative and the budget needs to be more resilient, which means expenditure must be more aligned with revenue growth.

The fiscal restraint challenge

The decision to downgrade SA to junk status means the country will have to go into debt counselling for a number of years. National Treasury will now have a fine financial tightrope to walk. How to exercise fiscal restraint to keep our foreign creditors at bay while fulfilling the mandate of poverty alleviation will be the greatest challenge.

Wasteful expenditure has become the scourge of society, says Patrice Rassou, head of equities at Sanlam Investment management. For all the juggling by our technocrats at the financial heart of government, the real economy is not creating enough jobs, growth has been lack-lustre as commodity producing economies took great strain driven by a severe correction in commodity prices. And in the real world, business confidence has remained low and an impediment to investment and job creation, with public sector enterprises unable to take on the baton of creating enough jobs to absorb growing youth unemployment. Demands on the treasury are many – free tertiary education, better and more affordable healthcare for all among others.

Despite this, SA corporates are stalwart survivors

For over 8 million unemployed South Africans, an economy which is not growing and creating jobs is cause for much hardship. And this lack of growth is in stark contrast with financial markets, which seem disconnected from the real economy. Don't be too surprised by this conundrum; Credit Suisse found that for the past century (1900 to 2016), the JSE delivered the best stock market returns in the world, outstripping the likes of the US, UK and all the European nations. This shows that our corporates have outlasted world wars, economic isolation and periods of extreme economic mismanagement. Today, the JSE is dominated by global companies that derive most of their earnings outside of our borders with the largest listed stock Naspers, owning a stake in Chinese internet giant Tencent, which is the largest emerging market stock by market cap! So for our clients invested in a diversified portfolio of assets on the JSE, there is some matter of comfort that the SA Inc. has stood the test of time when it comes to financial performance.

Can we deliver the change the economy needs?

However, the bigger existential question that we face is whether the shift towards more radical economic transformation will deliver the changes we need in terms of better education and jobs to alleviate economic hardship. Our foreign creditors, who own over a third of our government's debt, are watching closely. In a low-growth environment, Government's job should be to focus on reducing wasteful expenditure in state-owned enterprises and incentivising the private sector to create jobs in South Africa – something President Trump made his election mantra. Any economic misstep will hit the poor the hardest, resulting in foreign capital giving our shores a wide berth. Higher cost of servicing our debt will mean that there will be less money for social grants and a weaker exchange rate will fuel inflation, which will increase the cost of living for all South Africans. For those with pensions invested on the JSE, our philosophy is to invest in companies with solid business models trading at attractive valuations as the best way to protect your savings. Good companies can withstand economic turmoil through a diversified business model and by focusing on defending their margins. Unfortunately, however, this could be at the expense of job creation.

Concludes Rassou, it was Buffett who advised on investing in businesses with safe 'moats', ie those with a sustainable competitive advantage because, he says, "you should invest in a company that even a fool can run, because someday a fool will".

"How policy makers respond to the downgrade is going to be crucial. If South Africa is to regain investment grade status, tough decisions are needed.."

The only fear of risk

Carl Roothman | BCom (Law); LLB; LLM (International Banking and Financial Law) | Head: Retail | Sanlam Investments

“The only thing to fear, is fear itself” – Franklin Roosevelt

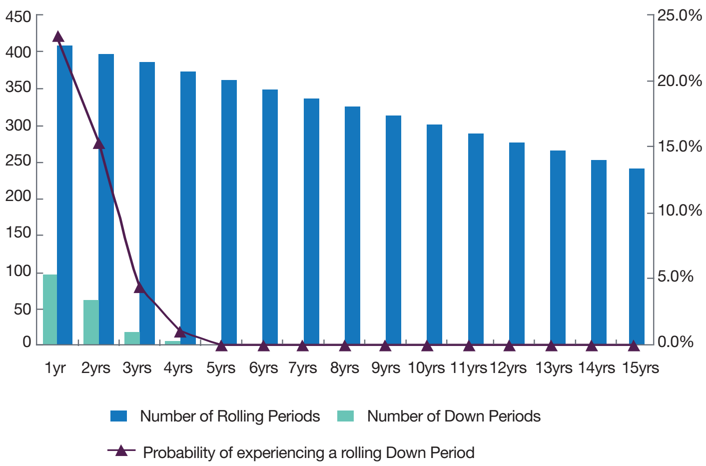
Market proponents advertise markets as inherently risky but what does “risk” mean in this context? More importantly, what does risk mean for the actual “end investor” and his/her financial wealth?

Defining risk

Academics define “risk” as the chance that an investment’s actual return will be different from what was expected, commonly known as “standard deviation”. To give you a practical example, if you expect the equity market to provide you with a return of 10% over the coming year, and the standard deviation is 15%, your return can vary from -5% (underperforming your expected 10% return) or up to 25% (exceeding your expectation).

In our view, risk should be defined as the actual risk of losing your invested capital. As we have seen, markets move in cycles and in the short term, the markets can be extremely volatile (note, not “risky” according to us, but volatile). Short-term volatility is perfectly normal – it is the mainstay of investing – and is completely different to the risk we’re referring to in this context, ie, the risk of losing your capital. As we are long-term investors, we are attempting to show you how “risky” the All Share Index can be in the short term, versus staying invested for the long term. We sourced data from the JSE’s All Share Index, dating all the way back to 1980, which is almost 35 years of actual return data on the All Share Index (please note this excludes dividends).

The chart below indicates the number of rolling periods since 1 January 1980 up until 20 October 2014. These rolling periods are separated into 1-year and 2-year rolling periods all the way up to 15 years of rolling data.



Source: Bloomberg

If you look at the one-year data, you will notice that there have been 407 rolling periods of one year across the mentioned data timeframe, with 95 of those periods being down. This therefore indicates that if you invest 100% in the All Share Index on any given day, there is a 23.43% probability that your investment will be worth less in one year than what it is today (again, we excluded dividends for this exercise).

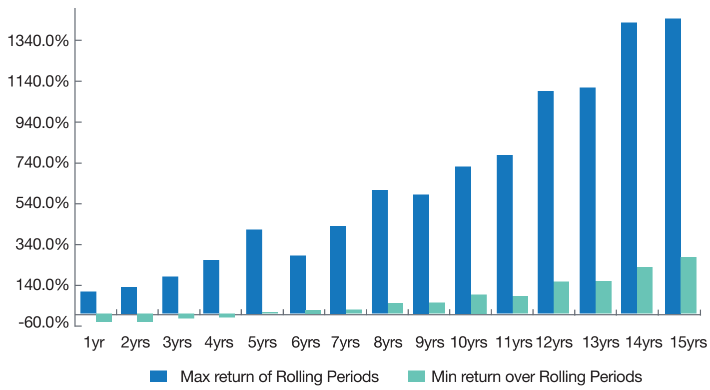
Investing is a long-term game

However, as you increase your investment horizon, you will notice that this probability of loss decreases dramatically. It is down to 15% in year two and if you have a look at year five, the probability is basically zero.

In very simple terms, the longer you stay invested the smaller the risk of losing your invested capital

So much so, that in the past 35 years, where the market experienced “Black Monday” in 1987 where the US markets dropped more than 22% in one day, the Russian/Asian Financial Crises in the late 90’s, the tech bubble and the recent “Great recession”, if you were willing to invest for five years or longer, you will not have lost any of your capital.

The chart below looks at the actual worst and best outcome over the various rolling return periods. What is noticeable here is that there is quite a range of outcomes in the first year (one-year rolling returns range from positive 110% to negative 38%). But as you move up in the time horizon, you will notice there are no negative returns.



Source: Bloomberg

We agree that markets can be “scary” sometimes, and no-one enjoys seeing the market in “red” as we have in the past couple of weeks. But it is of utmost importance – your financial future depends on it – to keep on investing for the long term, irrespective of the short-term price volatility .

"Discipline yourself to thinking long-term."

Stay invested in times of market uncertainty

Carl Roothman | BCom (Law); LLB; LLM (International Banking and Financial Law) | Head: Retail | Sanlam Investments

"Predictions are difficult to make, especially about the future" - Yogi Berra

Given current market volatility, it may be tempting for you as an investor to "time" the markets to avoid losses and maximise gains. In timing the markets, investors try to predict when the equity market is going to move up or down, and switch in and out of cash and equities accordingly.

However, time has shown that investors are better off resisting the temptation to make changes to their long-term plan, and not reacting to short-term market movements. This is because if you sell your shares in a panic as they fall, you might miss out on the recovery as the markets rise again - timing the market is just not worth the risk.

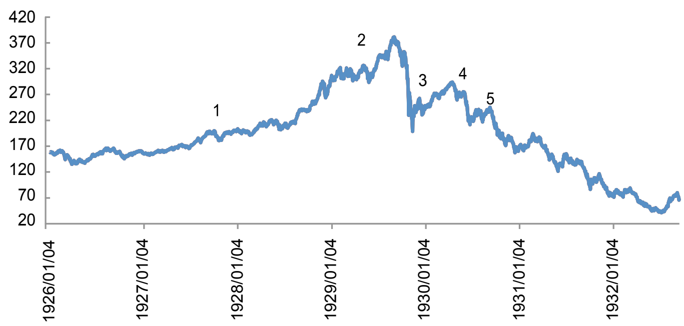
Don't bail out of your long-term plan, stay calm, stay invested and stay the course!

If history is anything to go by, short-term volatility is perfectly normal in equity markets. This volatility can result in a wide range of positive or negative outcomes depending on the position that you took (and more importantly, when you took that position). Although historically, stock markets have risen far more than they have fallen, and the long-term trend of the markets has been upward, it is extremely difficult to predict when the market is going to go up or down. Few investors can predict with any degree of certainty when, and by how much, the markets will rise and fall.

Many of us believe that it is actually impossible to "time" the market. In reality, market data also indicates that trying to time the markets can be a costly strategy.

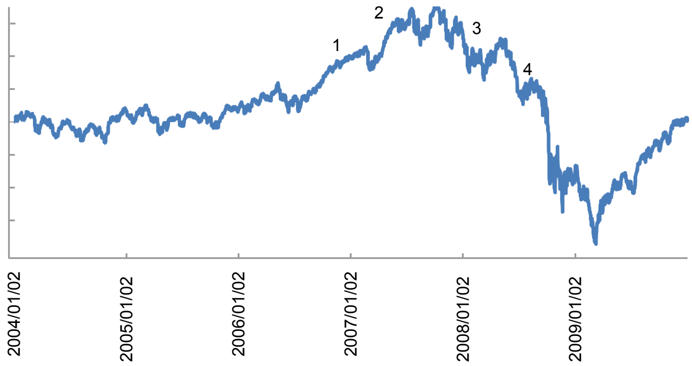
Below you will find two charts of the Dow Jones Industrial Index ("Dow Jones"), the first being the price chart for the "Dow Jones" during the Great Depression (during the 1930s) in the United States, and the second being the price for the same index during the recent financial crisis.

The idea is not to point out the mistakes made by market participants, but purely to point out that not even industry's greatest minds can successfully "time" the market.



Source: Bloomberg

1. "We will not have any more crashes in our time" - John Maynard Keynes, 1927
2. "There may be a recession in stock prices, but not anything in the nature of a crash" - Irving Fischer Ph.D. in Economics and a leading US economist, 1929
3. "This is the time to buy stocks, any man who is bearish on America will go broke" - R.W. McNeal
4. "There is nothing in the situation to be disturbed about" - Andrew Mellon, Secretary of the US Treasury, 1930
5. "There is evidence that the severe phase of the recession is over" - Harvard Economic Society, 1930



Source: Bloomberg

1. "The world economy is stronger than I have ever seen it" - Hank Paulson, Secretary of the US Treasury, Nov 2006
2. "If you wait too long to buy, you will miss out" - Tobias Levkovich, Chief US Equity Strategist, Citigroup, 2007
3. "The state of macroeconomics is good" - Olivier Blanchard, Chief Economist of the International Monetary Fund, 2008
4. "The financial system is sound and resilient" - Hank Paulson, Secretary of the US Treasury, September 2008

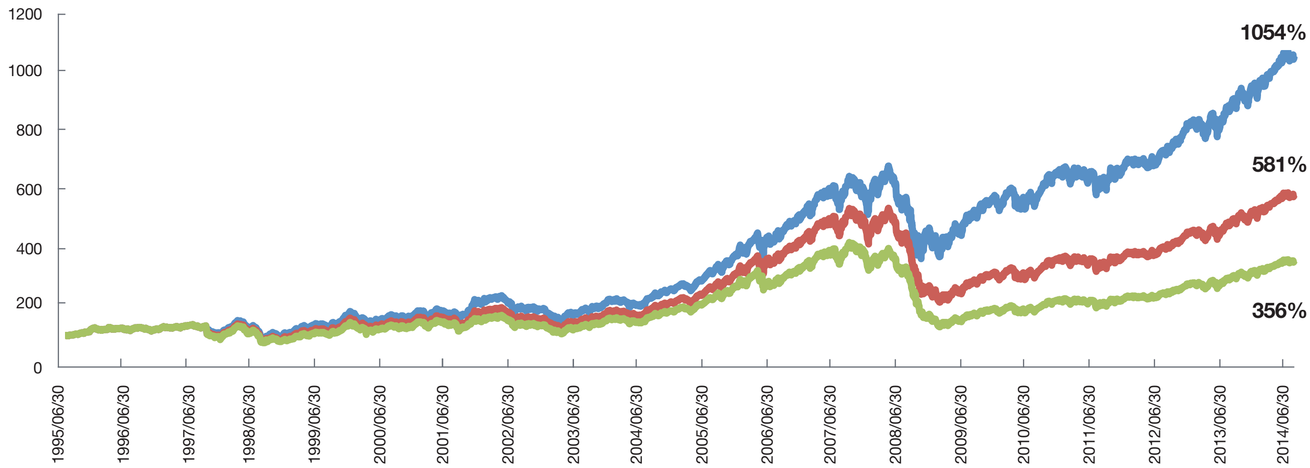
As mentioned, the aim of this article is not to point out the mistakes others make, but rather the error in thinking that you have the ability to "time" the market and highlighting what that "mistake" will actually cost you.

The chart below illustrates the impact of missing out on the best 10 and 20 days on the All Share Index in a period of nearly 20 years. We sourced the daily returns of the JSE's All Share Index dating back to 30 June 1995 and calculated what your returns would have been if you'd invested R10,000 on the 30 of June 1995. We also calculated what your returns would have been had you attempted to time the market and missed out on those 10 and 20 days with the highest returns over that time (please note this data does not include dividends received).

The problem with market timing: Missing the best days

19 Years of data 30-06-1995 to 02-09-2014

R10 000 invested in the All Share	Alll Share annualised return	Value of R10 000 invested of the	Gain | Loss	Impact of missing days
All 4793 trading days	13.2%	R105 458.63	R95 458.63	
Less the 10 days with the biggest gains	9.7%	R58 066.54	R48 066.54	-49.65%
Less the 20 days with the biggest gains	6.9%	R35 528.46	R25 528.46	-73.26%



Source: Bloomberg

They say a picture is worth a thousand words, in this case the picture (or chart), is worth thousands of Rands…

If you missed the Top 10 trading days in the All Share Index in your attempt to time the market, your return would have been **49.65%** less than the investor who stomached the volatility and stayed the course. If you missed the Top 20 trading days, your return would have been an agonizing 73.26% lower relative to the All Share Index!

In light of the above, we agree with John Bogle (founder of the Vanguard Group, one of the biggest index providers in the world), "… **not** investing is the only way to guarantee that at the end of the line you'll have nothing".

We accept that if you actually did successfully "time" the market and missed the worst 10 days, you would have had significantly higher returns compared to the market. But in the words of John Bogle - "no-one can time the market, if they say they can, they are lying".

Take this chance to sit back and review your personal investments in the context of your financial objectives and risk appetite, not short-term market performance. If your personal circumstances and investment goals are unchanged, stay committed to your long-term investment plan.

"Time is your friend; impulse is your enemy."

This article is not intended to negate investment processes that manage against extreme optimism and pessimism in markets, and which may involve tactical asset allocation from time to time when extreme market events call for it. During different times of the market cycle or as investment needs dictate, investors may well need greater exposure to equities (risk) and at other times less, while remaining diversified across the entire asset class spectrum.

The concept of timing in this article refers to investors jumping impulsively in and out of the equity market and into cash. What we wish to convey is that investors should leave the decision-making up to their experienced fund managers to utilize a robust investment process, and maintain a diversified allocation to different asset classes across their total portfolio including (and probably most importantly), equities.

Stay the course.

"We accept that if you actually did successfully "time" the market and missed the worst 10 days, you would have had significantly higher returns compared to the market. But in the words of John Bogle **- "no-one can time the market, if they say they can, they are lying."**

Retirement funding for private individuals* (part 2)

Edrich Jansen | (M Com) UP | Junior Analyst | FIRSTGLOBAL Asset Management

At the core, any retirement product is a mechanism of social security, designed to provide an income to those people whose income stream stops, gets disrupted or was never adequately developed to begin with, in order to escape destitution. Admittedly, destitution is at the far end of the spectrum, but not only is this the reality of the vast majority of South Africans, it can happen to anyone who fails to plan properly for their retirement. Most people are ambivalent when it comes to the various retirement products available, and very often individuals make uninformed decisions due to their lack of knowledge regarding retirement products.

In Part 1 of this two-part series, we covered the features of the various retirement products for private individuals related to their legal and tax structures. In this edition, we will narrow our focus and first look at some of the differences between typical retirement funds (RA, pension fund, provident fund, pension preservation and provident preservation fund) and investment linked living annuities (ILLAs). One of the best ways to educate and familiarise ourselves with something is by way of example, and we will therefore conclude with a practical example to show the workings of an ILLA.

The first fundamental difference between pension funds and ILLAs is the occupational aspect and the fact that the one is a pre-retirement and the other a post-retirement product. If you work for a company that offers a pension fund, membership will be compulsory and a condition of your employment, provided you meet the eligibility requirements. In other words, you have no choice but to join the fund. Conversely, an ILLA is a post-retirement product for individuals who need to annuitize two thirds of their retirement funds and who prefer flexibility and control over their income and investment risk.

A retirement annuity (RA), also a pre-retirement product, differs from pension and provident funds in the sense that no employer-employee relationship needs to exist. An ILLA can only receive proceeds from a retirement fund (RA, pension, provident and preservation fund) or another living annuity, meaning that no discretionary funds can be used to purchase an ILLA.

Another very important distinguishing element between the two structures is their compliance with Regulation 28 of the Pension Funds Act and Exchange Control legislation. Regulation 28 limits the exposure that pension funds can have to certain asset classes. In particular, they cannot have more than 75% equity, 25% property and 25% offshore exposure at any given time. This limitation however does not apply to ILLAs that are **member-owned** and therefore, as some readers may recall from the previous article, the responsibility of choosing an appropriate underlying fund falls onto the shoulders of the individual. However, the fact that the Regulation 28 limitations does not apply to ILLAs does not necessarily mean they are more risky retirement vehicles. An individual choosing an ILLA is under no obligation to choose an underlying fund with high equity or international exposure, and may choose a low equity or even an income fund.

No matter what pre-retirement vehicle you used (pension, provident, preservation or retirement annuity) to prepare for retirement, once the big day arrives you can take one third in the form of a cash lump sum, and with the remaining two thirds of your retirement fund you have to purchase an annuity. An ILLA offers you a flexible investment vehicle where you will be able to choose your income each year (within the subscribed limits of 2.5% - 17.5%) as well as the risk you are willing to take on. Any remaining capital after your death will pass onto your heirs and not your estate, whereas with a pension fund the process is a lot more cumbersome, as the trustees have the authority to distribute funds to beneficiaries.

An individual can benefit significantly in the form of tax savings by commuting the "correct" amount of their retirement benefit to an ILLA. For instance, if an individual has a marginal tax rate of 41% or 45%, it would be beneficial to commute the entire one third in cash since the first R500 000 is tax free and an amount above R1 050 000 is taxed at 36%. It can also happen that a person with retirement benefits of R6 000 000 only requires an income of R350 000 per annum (before tax), putting him/her in the 31% marginal tax rate. In such a scenario, it would be beneficial to take a lump sum of up to R1 050 000, which is taxed at 27% according to the 2017 tax table for retirement fund lump sums, instead of the R2 000 000 (one third) which he/she is entitled to commute. The remainder can be invested in the ILLA and a drawdown rate, equating to a lower rate of tax on the future income withdrawal, can be selected.

The primary factors that should be taken into consideration when choosing the underlying investment of a living annuity includes your income, fees and the risk you are willing to take. Broadly speaking, individuals can invest in a low, medium or high equity portfolio, depending on how much volatility they are able and willing to endure. High equity portfolios will invest in growth assets such as stocks and property which tend to be more volatile than low equity portfolios, which invests predominantly in bonds and cash.

The best way to illustrate the workings of an ILLA is by way of example. Let's assume you are 65 years old, have accumulated R5 million for your retirement and decide to draw an initial income of 6% of your savings. This translates to an income of R300 000 in the first year or R25 000 per month, before tax. Bear in mind that this 6% can be adjusted annually according to your needs, illustrating the flexibility benefit of an ILLA. As long as your investment returns exceed 6% per annum, you will be able to withdraw the same amount without losing any capital into perpetuity. If, however, the investment returns were less than 6% over the short term, you will start eating into your capital.

In simple terms, as long as your drawdown rate remains lower than your investment return, your ILLA investment value will never decrease. The risk is that the amount you want to draw may eventually exceed the maximum limit of 17.5% of your remaining savings due to inflation. In this scenario, you may end up with increasingly less income every year in real terms. The Association for Savings and Investments South Africa (ASISA) provides guidelines on the appropriate drawdown rates as well as tables showing the impact certain drawdown rates will have on your income at various levels of investment returns.

For more information in this regard, **click here**. Clients are advised to always obtain professional advice when it comes to retirement planning and the election of options, followed by sensible investment and management thereof.

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