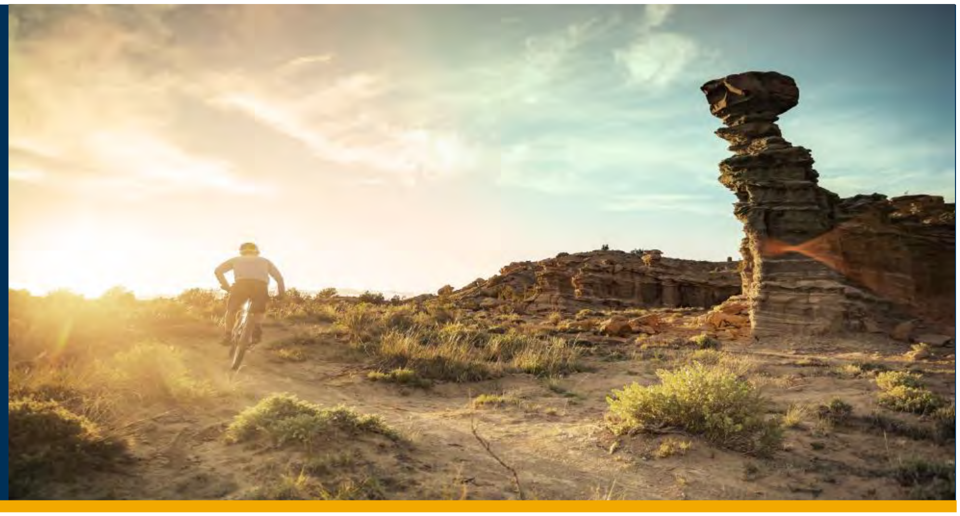
CLUCASGRAY
ASSET MANAGEMENT

ClucasGray Asset Management Quarterly Commentary

September 2016



Introduction

With South African politics having dominated public discourse over much of the last year, it is worth reflecting on developments over the last few months. Notwithstanding fears in certain quarters, the local government elections proved once again the strength of the country's relatively young democracy. Peaceful elections saw significant changes, with the official opposition party, the DA, gaining control of three of the country's larger metropoles – Johannesburg, Cape Town and Tshwane. In addition, several key rulings by the Constitutional Court re-emphasised the independence of the Judiciary and the strength of South Africa's constitutional democracy. Sadly, not long after the successful elections, rumours again surfaced of a potential arrest of the Minister of Finance. The ensuing sell-off in the Rand, bond market and certain equities was reminiscent of the tumultuous events of December 2015. To date, the rumours have proved unfounded.

As mentioned in prior quarters, the ability to fall back on an investment philosophy based on fundamentals, and a robust and active investment process has, we believe, enabled ClucasGray to take advantage of some dislocations in the prices of assets and asset classes over the last few quarters.

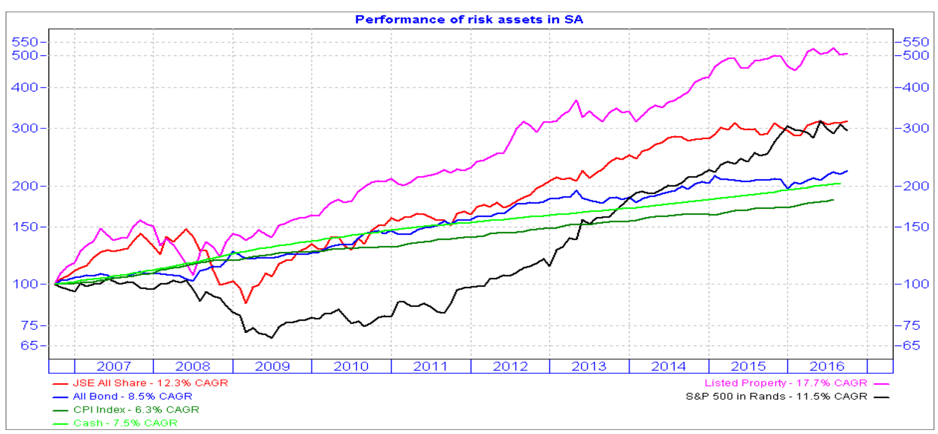
As custodians of our clients' savings, we constantly ask ourselves the questions:

- What risks should investors be wary of?
- What are we doing to mitigate against these risks?

These are extremely relevant questions and, at ClucasGray, we see our ultimate purpose being to generate real returns for our clients over sustained periods. Naturally, permanent loss of capital is every investor's ultimate fear. The less obvious risk is when returns underperform inflation for any length of time, leading to a relative loss of purchasing power. It is this second concern we would like to explore in a little more detail, as we currently believe there are a number of significant risks facing South African investors.

Investment Environment

South African investors have enjoyed exceptional real returns from all major asset classes over the last 10 years. As evidenced in the following chart, even cash has delivered a compound return of 7.5%, generating a 1.2% real return over 10 years.



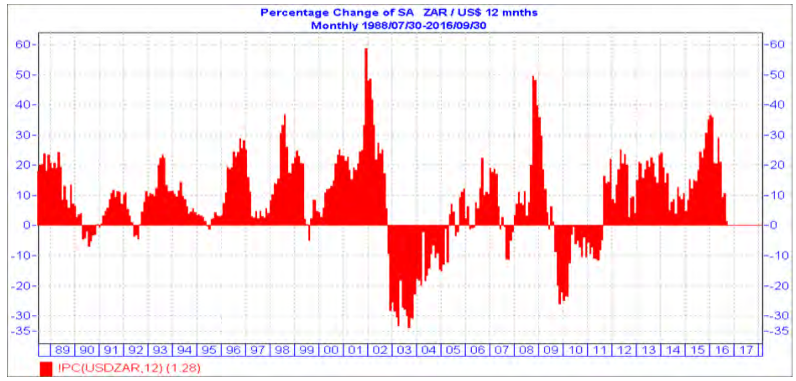
With the above major asset classes forming the building blocks to South African Multi-Asset portfolios, most investors would have enjoyed decent real returns over the decade. What is perhaps less obvious from the chart, is that the major drivers of returns (Listed Property and Equities) have moderated over the last 12 months

Equity returns over time are typically generated by two major drivers – a growth in company earnings or an increase in the Price to Earnings (PE) multiple of a company. Over time, it is the ability of companies to grow their earnings ahead of inflation that has resulted in strong real returns from equities.

We have previously articulated our concerns around market valuations, with PE's of many large companies trading at elevated levels relative to their long-term history. Of growing concern for us is the ability of certain large companies to grow their earnings bases sufficiently to justify their current ratings.

A recent study by RMB Morgan Stanley, shown below in the left hand chart, calculated that an estimated 73% of 2016 earnings of the JSE Top 40 Index are generated offshore.

Source: RMB Morgan Stanley

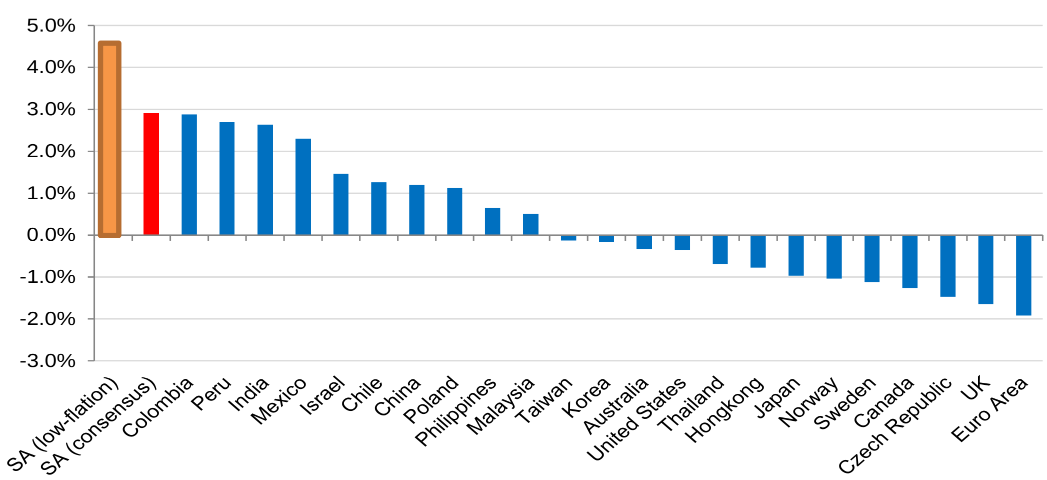


Source: Inet

With the Rand having depreciated by nearly 18% per annum since 2010, it is clear that currency weakness has been a contributor to the strong growth in earnings the JSE has enjoyed over the last 5 years. The red chart above shows the annual percentage change of the Rand – for the first time in 5 years the Rand has now strengthened year on year. Having been a tailwind for the JSE earnings base for much of the last 5 years, companies now have to deal with the currency as a potential earnings headwind. We believe consensus earnings forecasts continue to use a materially weaker currency in 2017 and 2018, so the longer the Rand remains at or below current levels, the larger the potential for earnings downgrades. We don't believe current valuations provide much comfort in that scenario and, as such, have taken measures in our portfolios to mitigate against some of these risks.

For much of 2016, there has been robust debate around the potential for a South African sovereign debt downgrade. Whilst a downgrade below investment grade would clearly be negative on many fronts, our approach has been to focus on the investment implications thereof, and to position our portfolios accordingly.

The chart below reflects the effective country risk premium of South Africa – the real 10 year government bond compared to numerous other economies. With an expected inflation of around 6%, South Africa's real bond yield of nearly 3% is at the high end of all investment grade sovereign bonds. However, RMB Morgan Stanley estimate inflation could fall towards 4,5% if the currency remains stable at current levels, placing our real bond yield close to 5% - significantly above peers and, in our view, potentially already pricing in a downgrade.



Source: RMB Morgan Stanley Research

ClucasGray Equity Fund

The end of September 2016 marks a significant milestone in the history of the ClucasGray Equity Fund, as the fund has now been in existence for 5 years. Since its inception in 2011, the fund has delivered compound annual returns of 14%, net of fees - this compares favourably with the General Equity Unit Trust peer group, which returned 12% per annum over the same period.

Within the ClucasGray Equity Fund, we have reduced exposure to the larger Rand hedge industrial companies. Given the potential for slowing earnings growth, as outlined above, and PE multiples that appear stretched, we believe there is a risk that many of them struggle to generate real returns for investors in the next few years.

Our view on the South African banks has not changed – we continue to view them as extremely attractive investments, with low PE multiples, high dividend yields and the prospect of steady, if not spectacular, earnings growth. Recent periods of currency instability have enabled us to add to our positions in the fund. It seems only a non-fundamental event can derail the investment case for banks, and they appear to have more than discounted any potential sovereign downgrade.

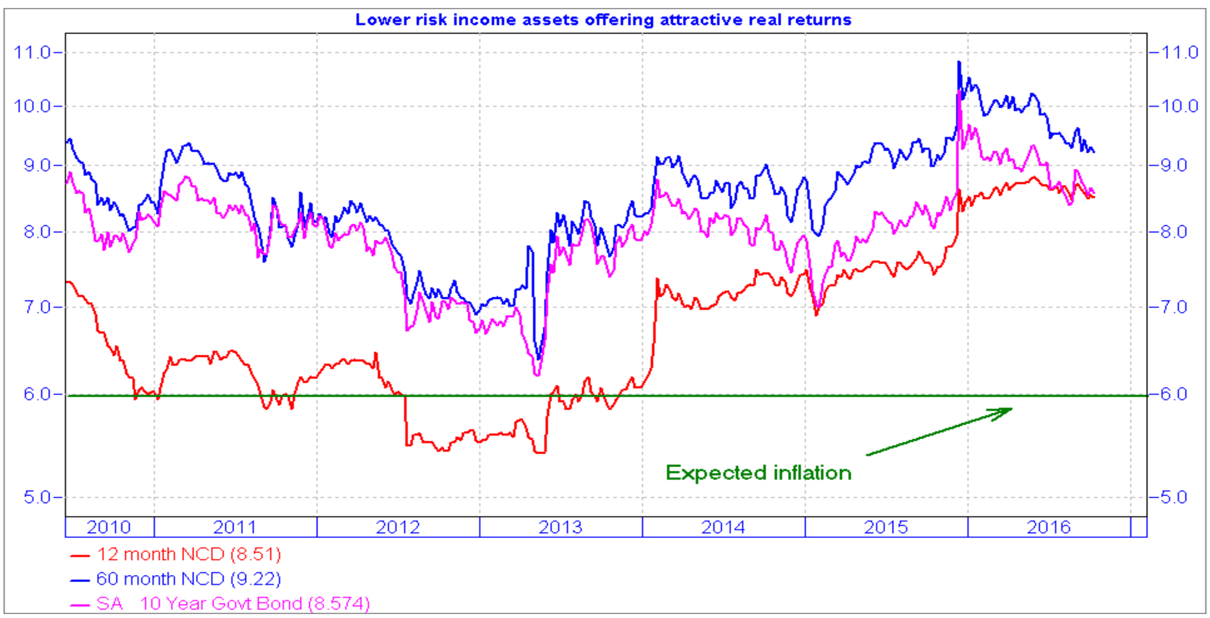
The fund has been able to take advantage of what we deem to be mispricing in a number of smaller companies, each with their own unique investment case. Some are attractively valued with low PE's, high dividend yields and good cash flow generation, others are high quality businesses with the potential to employ "self-help" strategies to unlock value, and a few have some economic tailwinds that we believe will provide support to earnings.

Notwithstanding our overarching concerns for select equities, which by virtue of their size have a bearing on the performance of the JSE Indices, we believe there are sufficient opportunities available, which should reward patient investors.

ClucasGray Equilibrium Fund

The ClucasGray Equilibrium Fund, our multi-asset Regulation 28 compliant unit trust, has a number of different levers to pull to generate returns for investors. The positioning within the equity portion of the fund is very similar to that of the Equity Fund.

One of the consequences of the potential sovereign downgrade has been the elevated yields on offer in South African income assets. The chart below shows the yields in a few NCD's and the 10 year Government Bond, with the expected level of inflation of 6% - as mentioned earlier this could be at the high end of forecasts in 2017. We believe investors have been presented with a window of opportunity to lock in attractive real yields in the Equilibrium Fund - over the last 9 months we have added meaningfully to longer dated NCD's at interest rates in excess of 9%. At the end of September 2016, 35% of the Equilibrium Fund was invested in cash, bonds and preference shares, with an average yield of close to 9%



With the proliferation of investment risks alluded to earlier in the report, these real yields, at relatively low levels of risk, are an important component of the fund's quest to generate sustainable real returns for investors over time. It is interesting to note that the ability to earn real returns from income assets is not afforded to investors globally, where real yields are in negative territory in many instances. For this reason, the fund's income assets are likely to maintain a bias towards South Africa.

Conclusion

In conclusion, over the course of the last year we have taken various actions to mitigate against some of the risks we believe investors are currently facing. Within the Equity Fund and equity component of the Equilibrium Fund, we have attempted to minimise the valuation risk where we see the potential for slowing (Rand) earnings, by investing in good quality, lower PE domestic facing companies. We have added to the yield component of the Equilibrium Fund by continuing to build exposure to a variety of income assets where the macro-political environment has provided the opportunity to "lock -in" attractive real income yields. Lastly, we are constantly re-evaluating the appropriate portfolio balance to avoid an unintended overexposure to the currency through a combination of direct offshore exposure, global exposure via domestic industrial shares and global property exposure.

For more detail on both the ClucasGray Equity and ClucasGray Equilibrium Funds, the Fund Fact Sheets are available on our website – www.clucasgray.co.za

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