ClucasGray Asset Management Quarterly Commentary

March 2017

Developments at National Treasury

The now infamous "night of the long knives" has resulted in a very different angle to our quarterly newsletter than the one we had originally intended. We will get back to our central, more fundamentally driven thesis a little later in the document, but stress at the outset that recent developments have in the shorter term rendered fundamentals more challenging.

We have spoken for some time about the steadily improving global economic environment and the positive impact that this will have on emerging markets, such as South Africa. We believe it is worth reflecting on the weak global economic backdrop towards the end of 2015 when "Nenegate" occurred, where developed market central bankers were fighting deflation, commodity prices were extremely weak, the combination of which resulted in a poor environment for emerging market currencies.

It is of little comfort that the current global backdrop is more constructive. The national despair around the seemingly unnecessary purge of the National Treasury is no less significant, but the fortunate reality is that activity levels globally have picked up, global economies are reflating, commodity prices are firmer, and most emerging market economies are experiencing an economic recovery. There is no doubt that the recent events have caused untold and unnecessary "self-inflicted" damage to the immediate prospects for the local economy. To risk so much for what appears to be extremely narrow and dare we say it, self-serving motives is virtually beyond belief.

Management of portfolios in non-fundamentally driven markets requires a nimble approach, as gyrations and market dislocations can provide opportunities for investors. Our approach has been to ensure balance in our portfolios, by tilting towards those stocks and asset classes we think are mispriced, but balancing these against the risk of the investment case being derailed by external events. We do not, however, subscribe to the view that South African facing companies are to be avoided at all costs, and that offshore, rand hedge exposure is permanently paramount. The economy in SA has always been cyclical, the JSE has high quality and well managed domestic facing companies in which to invest, and at the appropriate times in the cycle they have delivered extraordinary returns for investors. We are of the view that the environment may also present long term investors with opportunities to buy good companies at very attractive valuations.

Investment Downgrade in Perspective

All readers are likely to be well versed in the more recent events of the downgrade by rating agency S&P of South Africa's offshore debt to below investment grade. This is an extremely disappointing development, with potentially severe economic implications. We make no attempt to sugar coat this downgrade – there is nothing economically positive that can emanate from a downgrade. This has been followed by Fitch downgrading both the foreign and local currency debt rating to below investment grade. Both S&P and Fitch have made reference to the risk of potential economic policy changes post the cabinet reshuffle.

The following table neatly encapsulates where South Africa currently stands as far as the 3 major rating agencies are concerned. There are 2 components to the various ratings, one for local currency debt and the other for foreign currency debt. As can be seen, S&P now have South Africa's Foreign Debt on sub investment grade. Moody's have both foreign and local debt at 2 notches above Investment Grade, with the possible risk that they will move us down to 1 notch above, and Fitch has downgraded both to sub investment grade.

South Africa	Moody's	S&P	Fitch
Investment Grade	A3	A3	A-
	Baa1	BBB+	BBB+
	Baa2	BBB	BBB
	Baa3	BBB-	BBB-
Sub Investment	Ba1	BB+	BB+
Outlook	Negative	Negative	Stable

Local Currency Rating
Foreign Currency Rating

Source: RMB Morgan Stanley

The foreign currency debt contributes 10% of total sovereign debt outstanding, so whilst these decision have implications for bond investors, the real damage that could be caused would come from additional downgrades to the local debt from either S&P or Moody's to below investment grade. Our understanding is that for South Africa to be excluded from the World Global Bond Index would require a sub investment grade rating on both foreign and local currency debt from both S&P and Moody's. Recent events would suggest that this is not impossible, but is not currently the reality.

Quarterly Market Overview

The performance of investment markets and equity sectors proved yet again to be divergent in the quarter. The JSE All Share Index gained 3.8%, the All Bond Index rose 2.5% and listed property gained 1.4%. The resource sector gained nearly 2% in the quarter, initially helped by surging commodity prices, and towards the end of March by the weakening Rand. Following a very strong performance towards the end of 2016, the Banks index fell over 6% in the quarter.

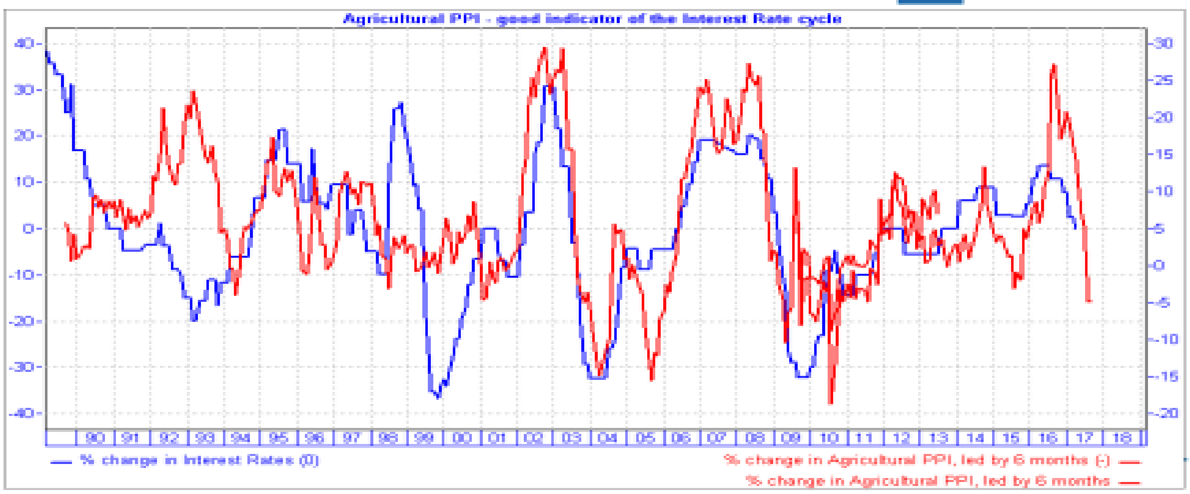
Notable performances in the period included the industrial heavyweights Richemont, Naspers and British American Tobacco all rising over 13% in the quarter. Amongst the smaller companies to which both the Equity & Equilibrium Funds are exposed, Zeder rose 10% and Adbee increased over 30%.

Notable underperformers in the quarter include Netcare and Barclays Africa each declining over 17%, and FirstRand losing over 10%. The banks unfortunately sold off dramatically towards the end of the March in the aftermath of the political developments. We explore the investment case for banks in general and Standard Bank in particular in a little more detail further in the quarterly. Netcare's woes were related to a very poor update on its trading performance.

Opportunity Lost or Merely Delayed?

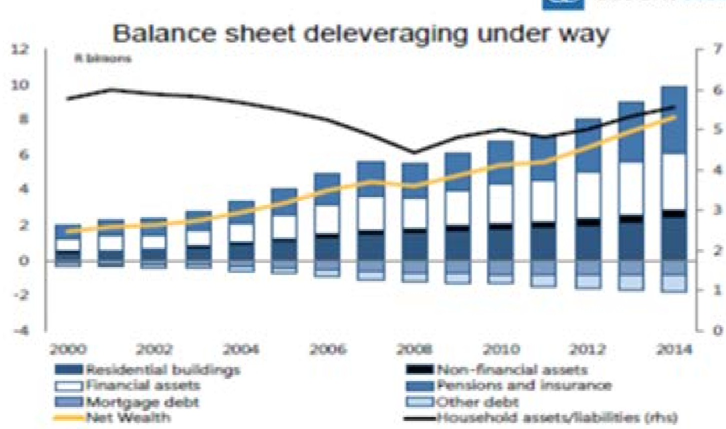
At ClucasGray Asset Management, we believe that macro analysis is an important supplement to fundamental company analysis. In that context, we thought it would be interesting to articulate our view on the South African consumer economy which has faced significant headwinds over the last few years. We alluded to these in the December quarterly - they include rising interest rates, high food inflation exacerbated by the drought, extreme currency weakness, and limited employment growth. In addition, weak consumer credit extension has amplified the situation for the demand economy. Given these developments and the amplified political uncertainty and noise that have dominated news flow over the last while, it is no surprise that consumer confidence levels have reached levels not experienced for many years.

We are of the view that a number of the constraints referred to above are in the process of alleviating. We would view Agricultural PPI as a good proxy for farm gate pricing, and hence it is intuitive that it has tended to be a leading indicator for food inflation – the most recent number of -5% points to an outlook for lower food inflation, and by implication overall inflation in the economy. With the good summer rainfall in much of the maize growing regions, we expect maize to be in surplus, leading to a sizeable drop in prices. Of additional interest is overlaying the interest rate cycle with Agricultural PPI – as evidenced by the chart below, Agricultural PPI has over time proved a very good leading indicator for interest rates.



Compounding the woes for retailers is that consumer credit growth has been negative in real terms for over 3 years. A large contributory factor to this has been that mortgages have barely grown in real terms since 2010. We believe that this is indicative of an extremely weak demand economy and has been borne out by the weak retail and vehicle sales numbers.

Given this sustained negative real consumer credit growth, national household balance sheets are in a much better state than they have been for some time. The chart to the right, courtesy of RMB Morgan Stanley, neatly encapsulates the rebound in household assets relative to liabilities. Household assets have, in aggregate, been rising in real terms, wage increases have outstripped inflation, and the economy has seen net employment growth since the 2008 financial crisis. The net effect is that the national household balance sheets are more robust than they have been for nearly a decade.



We were of the view that, barring any material non-fundamental developments, the environment was becoming more conducive for the Reserve Bank to adopt a more stimulatory monetary policy stance and that interest rates were likely to start to trend downwards. This thesis may yet prove relevant, with weak demand and falling inflation – the timing thereof has, however, become more uncertain.

Investment Implications

At ClucasGray Asset Management, we are constantly on the look out for mispriced assets - we adopt a fundamental approach to valuing companies and asset classes, but acknowledge that a view on the macro environment in which companies operate is an essential supplement to our investment process. Within equities we look for companies that have the ability to generate good real earnings growth, and/or have the prospect of a re-rating.

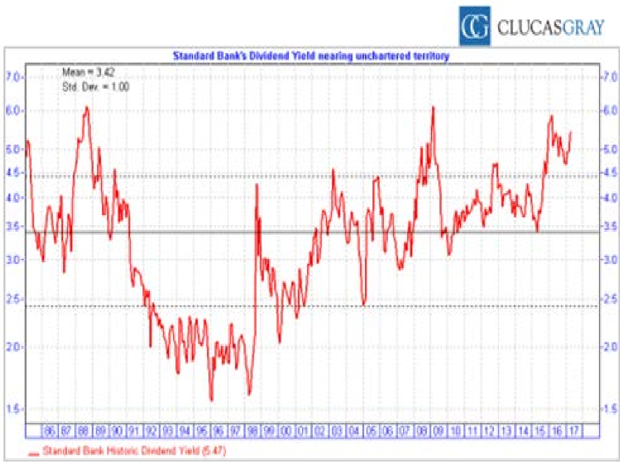
We happen to believe that a number of South African consumer related and financial companies are currently attractively valued. The environment in which they have operated over the last few years, as articulated above, has been tough, and earnings growth in a number of these companies has been muted. They remain high quality businesses, generating high ROE's, have strong balance sheets, and are well run companies that have proved themselves over many differing economic cycles. One such sector we have been heavily exposed to for some time is the SA Banks, given what we deem to be attractive valuations, strong balance sheets and reasonable earnings prospects.

Standard Bank Summary Investment Case

Notwithstanding a tough operating environment, Standard Bank's Banking earnings grew by 10% In 2016, driven by a strong operating performance by both major operating entities, Personal & Business Banking (PBB) growing 12% and Corporate & Investment Banking (CIB) growing 16%. What we found encouraging about the operational results was the fact that they didn't release impairments to boost earnings, choosing to rather maintain provisioning levels at elevated levels. The ROE in the banking operation increased to 17%, continuing the improving trend over the last 5 years.

All the SA Banks are generally extremely well capitalised. Having reduced gearing meaningfully over the last number of years, Standard Bank now has a Core Tier 1 Capital ratio well in excess of the upper end of their target band. Given this lower gearing, we believe the current ROE is of a far higher quality than in previous cycles – the banking group's return on risk weighted assets is now materially higher than it has previously been. This balance sheet strength, allied with an improving ROE has enabled them to increase the dividend by 16%, and still have sufficient capital to fund any potential increase in demand for advances.

The most material disappointment for Standard Bank has been the performance of Liberty, which saw a decline in earnings on the back of a number of one-off events. We believe many of these are likely to not reappear in 2017, which would result in Liberty providing a boost to Standard bank's earnings . The Group's well established African footprint is a key differentiator to some of their domestic peers and, in our view this provides the group with long term earnings optionality as and when economic activity on the Continent picks up.



The group trades on attractive valuation multiples, with a forward PE multiple approaching 9x and dividend yield nearing 6% to December 2017 – as shown in the chart to the left, it has not often reached these valuation levels over the last 30 years. Our forecast is for solid, if unspectacular, real earnings growth from the Group over the next few years. This earnings growth, coupled with the prospect of a re-rating, leads us to conclude that Standard Bank is likely to generate attractive returns for investors from these levels. As such, it is a large weighting in both the ClucasGray Equity & Equilibrium Funds.

ClucasGray Equity Fund

The ClucasGray Equity Fund gained 2.1% in the quarter, helped by strong performances from, amongst others, Adbee, Naspers, British American Tobacco and Zeder. Some of the detractors in the quarter included Barclays Africa and some of the hospital groups. The JSE SWIX Index, the official benchmark of the fund, increased by 3.3% in the quarter, with Naspers' strong run being the major contributor to the Index returns. Although the fund underperformed the SWIX for the quarter, the fund has returned 6.1% over the year to end March, which is ahead of the SWIX's 1.6% return.

During the quarter we sold out of MMI Holdings – the life insurance group had performed well over the last year, and was trading closer to our estimate of fair value. We also reduced our weightings in The Foschini Group, given the strong rally in the share price.

We added a few smaller companies to the portfolio, including RCL Foods, Clover and Metrofile. RCL Foods, Clover and Zeder all trade at what we deem to be attractive valuations when their earnings bases normalise. We view the falling food inflation environment referred to earlier as beneficial to the likes of RCL and Zeder.

ClucasGray Equilibrium Fund

The ClucasGray Equilibrium Fund returned 1.9% in the quarter, lagging the peer group average of 2.6%. Over the last year, the fund is up 4.7%, which is ahead of the peer group returns of 2.1%. The changes to the equity carve out of the Equilibrium Fund are very similar to those of the Equity Fund.

Within the Equilibrium Fund's fixed income component, our strategy has been to take advantage of attractive yields on offer in the shorter duration income assets. We have preferred to take duration risk in select equities and listed properties that we deem mispriced and would perform well in a declining bond yield environment. By not doubling up on duration risk within the fixed income component, we believe we have shielded investors from the worst of the bond sell-off that occurred towards the end of March.

It has been a difficult environment for balanced fund investors over the last 2 years, with the average balanced fund being up 3.3% per annum over the last 2 years, disappointingly generating negative real returns for investors. In the same 2 year period, the ClucasGray Equilibrium Fund gained 4.8% - ahead of the peer group, but nonetheless behind inflation. We are firm believers in the benefits of actively managed balanced funds delivering attractive real returns over sustained periods of time. The ability to tactically switch between global and domestic asset classes, coupled with active selection of mispriced equities or listed properties make them very attractive long-term investment vehicles. We continue to target returns of Inflation plus 4% to 5% in the Equilibrium Fund. Since inception the Fund has returned 8.7% per annum, compared to inflation of 6.3% - a real return of 2.4%.

For more detail on both the ClucasGray Equity and ClucasGray Equilibrium funds and to view our latest fund fact sheets, please see our new website – **www.clucasGray.co.za**