CLUCASGRAY
ASSET MANAGEMENT

ClucasGray Asset Management Quarterly Commentary

June 2017

Introduction

There is little doubt that the political and economic landscape has caused some angst amongst many. The leaked emails relating to perceived state capture by prominent individuals provide for captivating headlines, and if even remotely true are extremely disconcerting on so many levels. Cabinet reshuffles referred to in the previous quarter, the radical transformation of the Mining sector proposed in the recently released Mining Charter, the apparent overreach by the new Public Protector in commenting on the Reserve Bank's Constitutional mandate, and the ever present risk of further rating agency downgrades are all unsettling.

The reality though is that markets do what markets do, and there is no point wishing away the prevailing concerns. If any country should have some perspective on political noise and the bearing thereof on the economy, it should be South Africa, given its extraordinary political history. We believe it is our role as active managers, and custodians of our clients' savings, to navigate our way through the issues of the day.

In previous quarterlies, we have articulated how the ClucasGray Asset Management investment process is designed to uncover mispriced opportunities, be they companies or asset classes. The best time to invest in businesses is generally when earnings are suppressed, PE multiples are low, and the currencies in which they operate are relatively weak. We find this a useful framework around which to analyse individual companies, broad sectors, and asset classes in general.

Economic backdrop

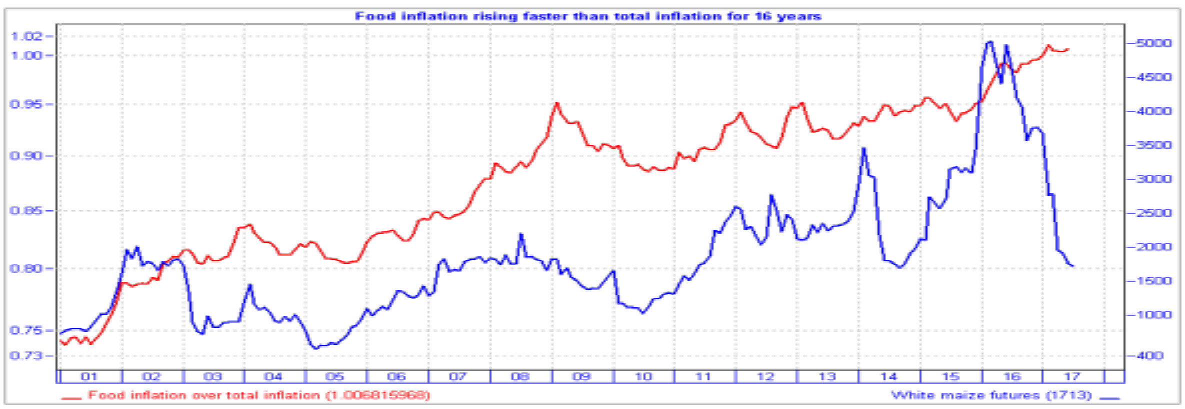
The recent strength of the global economy is expected to continue – we have seen strong evidence of rising economic activity in the US, encouraging signs in the Eurozone, and a steadily improving emerging market growth outlook. Inflation, long subdued, is moving gradually higher, and although protracted, we believe we are in a normal cyclical upswing globally. The diagram below depicts how we interpret the current state of the global economic cycle – a period of modest reflation where growth recovers. Traditionally this backdrop has been favourable for equities, which rally in anticipation of stronger company earnings, and less favourable for bonds, as yields rise in line with rising inflation. It has typically been good for emerging market growth, emerging market currencies and, dare we say it, commodity prices.

Source: Morgan Stanley

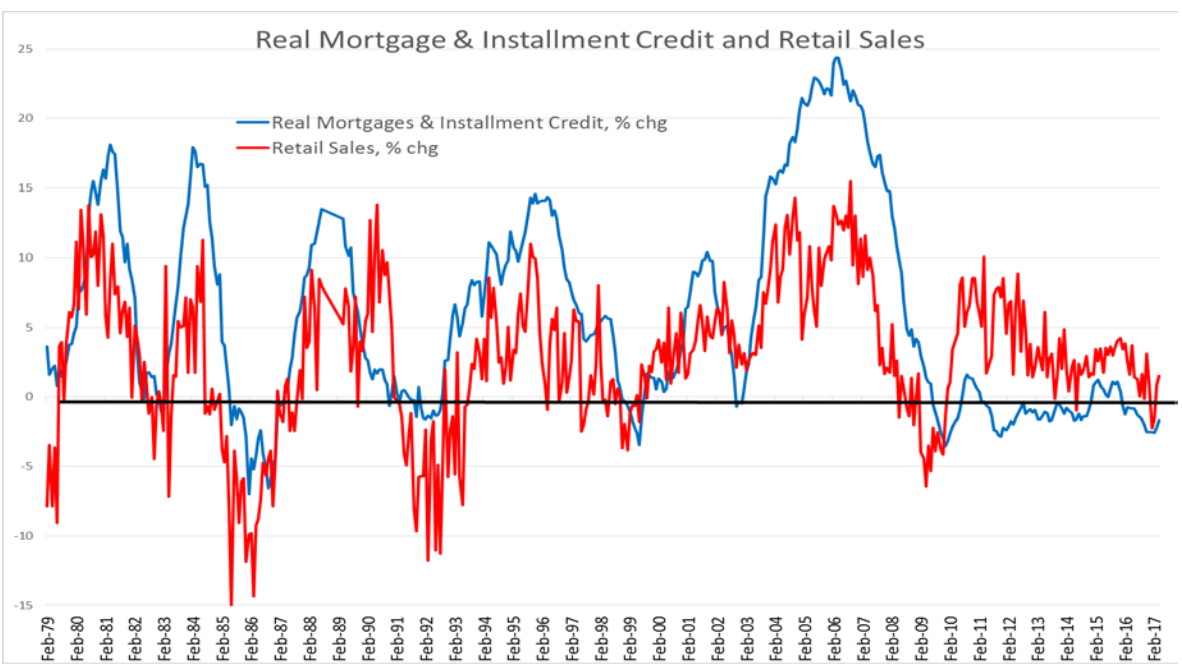
It has been our view that South Africa was to be a beneficiary both of the improving global backdrop, and some domestic factors which we will explore in more detail later. Political developments have, if one believes all one reads, derailed any such development. We believe it is worth revisiting our logic around a cyclical recovery in South Africa, and exploring whether notwithstanding politics, the argument still holds.

The consumer economy in SA has endured many headwinds over the last number of years – the weak Rand, escalating food inflation exacerbated by the drought, rising interest rates and limited employment growth. Given the significance of food in the average consumers monthly expenditure, we find the below chart on the rise of food inflation concerning. It shows how food inflation has outstripped total inflation by a staggering 2% per annum over the last 16 years, which would have a negative impact on discretionary income levels. We have overlaid the price of White Maize onto the graph, as a proxy for the inputs into food inflation, and it is apparent that falling maize prices have historically seen food inflation rise slower than overall inflation – given the decline in maize prices, we expect this cycle to be no different as food inflation is expected to fall sharply.

Food CPI outstripped CPI by 2% per annum over last 16 years – relief in sight



As evidence of the lack of demand growth in the economy, we believe the chart below is instructive. It shows the percentage change in Retail Sales (red line), and a combination of Mortgage & Instalment Sales credit extension (blue line) as an indication for consumer demand.



Aggregate credit extension of these 2 major credit categories has been negative in real terms for much of the last 7 years – retail sales have recently dipped into formal recession, but it is evident that consumer stress has been building for some time. These charts date back to 1979, and highlight the cyclicality of the consumer economy – although never pleasant, it is not uncommon for the consumer economy to experience times of stress.

We have for some time been advocating for the SA Reserve Bank (SARB) to adopt a more accommodative monetary policy – inflation is now within the target range, and likely to fall towards the bottom of the range, and credit extension is extremely weak. We believe there are levers for the SARB to pull to assist the economy.

Perhaps one of the more disappointing aspects of recent comments from the Public Protector around the Constitutional mandate of the SARB, is that any action by the SARB runs the risk of being seen to be acceding to external political pressure – the reality is that they have done a remarkable job of curtailing inflation in the recent currency crisis and ensuring credit demand has been contained, to the extent that inflation is in rapid decline. The SA economy requires interest rates to be cut, and we sincerely hope that they start as soon as possible.

Political backdrop and potential implications

South Africans of a particular vintage are familiar with scenario planner Clem Sunter who famously spoke about the choices facing the South African Government in the 1980's. The high road and low road scenarios he sketched became engrained in the dialogue of the day, and his influence on the final negotiated settlement was significant. In many ways, South Africa today finds itself at a cross roads of sorts – we stress this is nothing near the scale of crisis faced in the apartheid era, but nonetheless there are choices to be made by those in power which have ramifications for all.

What would the investment implications be of a potential low road scenario playing out – further rating agency downgrades, exclusion from global bond indices leading to higher yields, currency weakness, a freeze on private sector capital expenditure and a political outcome that is less market friendly? Given the makeup of the JSE with foreign related company earnings making up over 65%, the listed property index with 40% of distribution income from offshore, and the regulatory offshore allowance of 25% within Balanced Funds, it is reasonable to conclude that a large portion of the savings industry is reasonably well placed in the event of a low road scenario.

We see a "muddle through" scenario being an interesting risk to investors. There is a chance SA does indeed get downgraded, but bond yields and the currency don't react - given our high relative real yields, and a currency that remains weak in real terms, it is not an unrealistic scenario. Coupled with a political climate that is more of the same, interest rate cuts leading to a recovery in the consumer economy, and GDP which slowly recovers off the current recessionary base, there is a reasonable chance that the macro environment is mildly supportive of local company earnings. Our investment process is designed to look for companies with the potential to grow real earnings, and which trade at attractive multiples – under a "muddle through" scenario we believe local investors could well be rewarded in select opportunities.

ClucasGray Equity Fund

South African equity investors have endured a roller coaster of a quarter, with the JSE rallying strongly for April and much of May, before selling off heavily towards the end of the quarter. During June, the JSE SWIX declined by 3.8%, led by a poor performance from some of the larger Industrial index constituents, and a very weak performance by Gold shares. The ClucasGray Equity Fund declined 2.4%, with the General Equity peer group declining 3.6%.

We do not take any joy in outperforming markets when they fall. Equity investors have enjoyed a very good performance from equities over the last 5 years, and we have articulated previously our concerns around valuations and earnings prospects amongst certain segments of the market. Whilst the Equity Fund is not immune to sell offs, we do attempt to shield investors by investing in companies that we believe to be mispriced, not merely because they are large constituents in an index. We believe that the political disruptions and slowdown in SA have created an opportunity to invest in good companies at what we deem to be attractive valuations. Over the last 12 months, the Equity Fund is up 3.1%, relative to the SWIX which is flat, and the peer group which is down 1.3%.

At ClucasGray Asset Management we are constantly looking 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. Our long term objective is to deliver on our investment promise of good industry beating real returns for our clients.

We thought it would be constructive to provide a summary of some interesting holdings in the portfolio, outlining the investment case and the rationale for including them in the Equity Fund.

Given the potential scenario outlined above, we have deemed it appropriate to tilt the portfolio towards some of the attractive opportunities we see in the domestic market. We continue to be well exposed to financials – banks and select life companies, where we see valuations as attractive relative to the market as we did in the 2008 financial crisis. This is clearly demonstrated in the below chart. In addition, these sectors have typically performed well into a falling interest rate environment.

RMB Morgan Stanley Research

Reunert is another company which continues to feature prominently in the portfolio. We like the balance sheet strength, history of cash flow generation, management has introduced clarity around their strategy to grow the business both organically and via smaller acquisitions, they are market leaders in their field of expertise, and we believe they are able to generate an earnings profile ahead of inflation over the medium term. Our valuation of the business reflects further upside from current levels.

The exposure to food producers is a theme we think will add value over the next few years. The falling food inflation dynamic referred to earlier is likely to result in margin expansion for the major food producers, and coupled with valuations which are attractive based on a more normalised level of earnings, we expect to see good returns from a number of these companies.

We must stress that whilst we believe there is a very good chance that the low road scenario does not pan out, we are mindful of the risks in the event it does. As a result, our portfolio construction includes a number of holdings which would protect the portfolio in such a scenario – companies that have large offshore exposure, but which importantly are attractively valued and should deliver reasonable hard currency returns.

ClucasGray Equilibrium Fund

The ClucasGray Equilibrium Fund, being a balanced fund, has more levers to pull to protect investors in a difficult equity market environment. The fund has an ability to invest in a range of asset classes (equities, fixed income, property and global), and so doing use active asset allocation and security selection to strive to deliver industry leading real returns for investors. Over the last 12 months, the fund has delivered a 4.3% return, relative to the peer group average of 1.3% - since inception in January 2015, the fund has delivered a compound annual return of 7.8% ahead of the peer group average of 4.5% per annum and inflation of around 6%. The industry's inability to deliver real returns in Balanced Funds for much of the last 2½ years is a concern for all investors. We do however believe that actively managed balanced funds are effective vehicles through which to deliver consistent inflation beating returns to investors – we continue to target returns of 4% to 5% ahead of inflation over time.

The Equilibrium Fund continues to hold around 33% in cash, short duration fixed income and preference shares – we have been able to lock in very attractive yields in this portion of the portfolio of over 9%. Given our view that inflation is likely to average around 5% over the next while, these are extremely attractive real yields. We often get asked why we don't hold even higher weightings in this relatively low risk, high yielding assets, which is an interesting question. We are of the view that the window of opportunity of high real yields will not last for long – we would expect these to narrow, most likely through a reduction in interest rates referred to earlier. History has taught us that in such an event, inexpensive domestic oriented companies typically perform well – more so when starting PE multiples are low.

During the quarter, the fund took advantage of some attractive valuations by adding to the equity weighting. More specifically we increased our exposure to select financials where valuations are nearing levels last seen in the 2008 financial crisis, and to select resource companies. The equity carve out of the Equilibrium Fund is similar to the Equity Fund, so the positioning referred to earlier is relevant for both funds.

The developments around the Cabinet reshuffle towards the end of March lead to certain global property companies performing well – we took advantage of this move to switch some of our exposure into more domestic property companies.

The Equilibrium Fund continues to hold less than the 25% permitted in offshore assets, with weightings currently at 18%, of which 16% is in global equity. The fund's offshore equity has performed well – our strategy is to apportion the equity between an active manager, and a range of passive index funds. The active manager has performed well; the strategy to reduce the passive exposure in global equity, and move into European and Emerging Market equities has to date worked well.

Outside of equities, the ability to deliver meaningful returns in offshore markets has proved elusive of late. Our analysis over the last 20 years suggests that to deliver real returns in Rands from offshore fixed income markets has been dependent upon currency weakness. In periods of a relatively stable or strong Rand, the returns to investors in Rands have been below SA inflation. Given the extremely low starting yields, we feel investors require further currency weakness to deliver real Rand returns from offshore fixed income assets. Whilst this is possible, it is by no means a certainty from current elevated currency levels. We prefer to take exposure to the higher yielding income assets on offer in SA.

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**