CLUCASGRAY
INVESTMENT MANAGEMENT

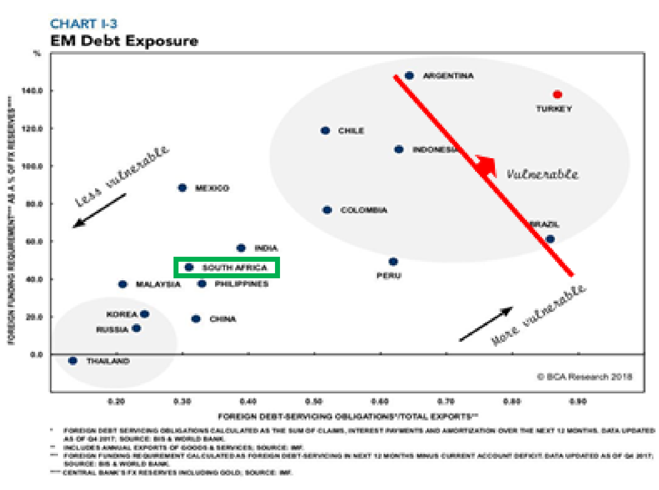
ClucasGray Private Clients Quarterly Commentary

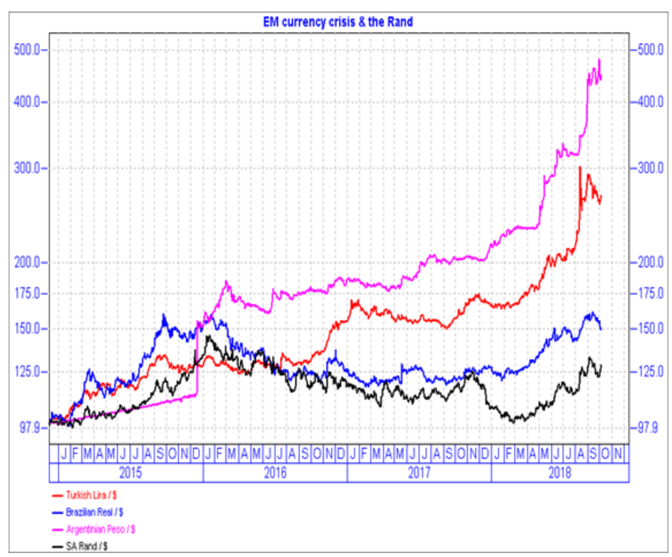
September 2018

Investment Environment

Global markets continue to grapple with much the same issues as they have for the last few years. These include a strong US economy, with muted growth in most other major economic regions; an end to accommodative monetary policy in the US, which is now well advanced in an interest rate hiking cycle, whilst interest rates in other developed economies remain very low; rising US Bond yields and the implications thereof for certain company valuations; continued strength in the US Dollar causing harm to emerging markets; President Trump and his trade wars, principally with China, and the potential consequences thereof for global growth in general, and EM growth in particular.

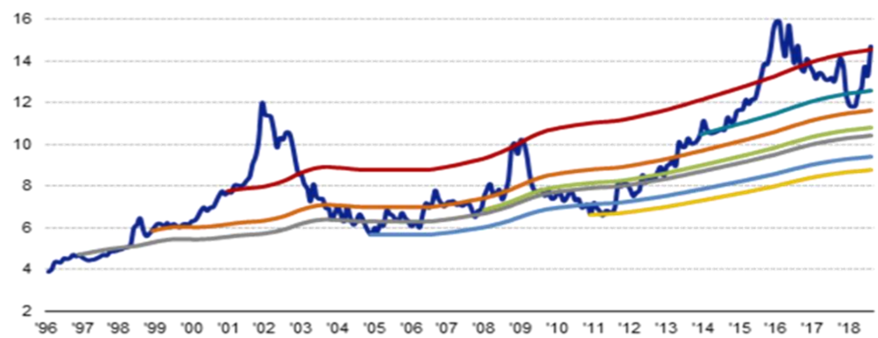
The current Emerging Market crisis gathered momentum in the 3rd quarter, with the currencies of both Turkey and Argentina weakening significantly against the Dollar. These economies have been at the epicentre of the crisis, given their elevated foreign currency debt levels, but yet again it seems contagion has spread to other emerging markets. It has been well documented that South Africa is not without it’s own economic troubles, but in our opinion the extent of the Rand weakness belies the true fundamentals - the Rand has now weakened by over 15% since January. The chart to the left below shows the level of vulnerability that certain economies have by virtue of their foreign debt obligations and foreign funding requirements. Whist South Africa is not completely immune, the chart does highlight how much more vulnerable the likes of Argentina, Turkey and Brazil are. The chart on the right shows the extent of the crisis in the extraordinary weakness of both the Argentinian Peso and the Turkish Lira – cold comfort for South Africans that the Rand has been relatively benign in comparison!





The Purchasing Power Parity (PPP) valuation for the Rand against the Dollar shown in the chart below, highlights the extent of the recent currency crisis. As evidenced in the chart, the Rand has seldom deviated further from it's PPP value - only in the 2015 EM crisis and Nenegate spike, and the 2001 EM crisis has the Rand appeared cheaper in real terms.

PPP valuation of the Rand vs Dollar

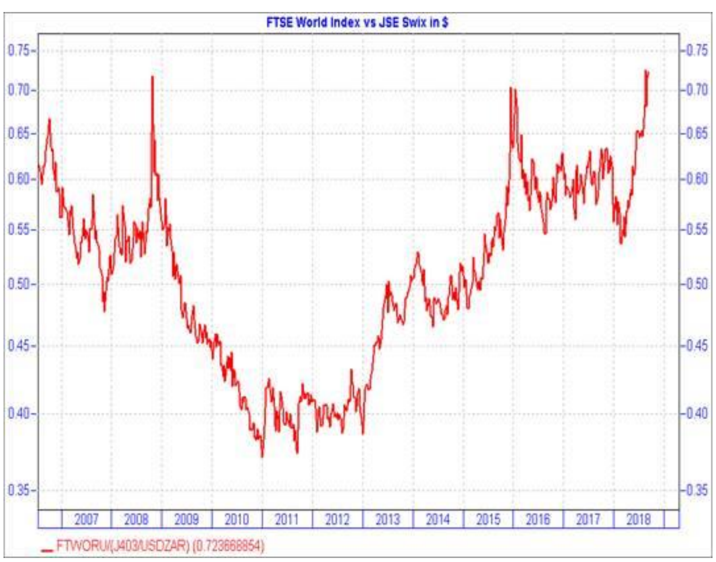


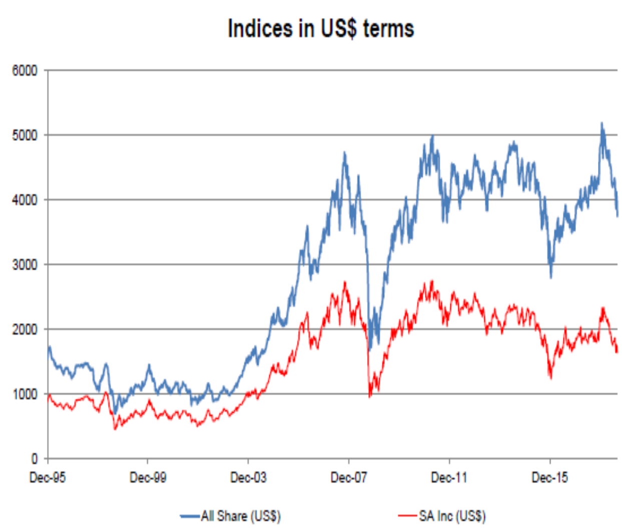
Source: Avior Research

We would take some comfort from the above chart – the Rand appears to be an inexpensive currency in real terms, and whilst calling directional trends in currencies is frequently futile, it would appear to us that we are a long way through the worst.

The other point to make is the one we made in the June 2018 quarterly – it is an anomaly that we experience such emerging market currency turmoil in the midst of a strong global economic cycle. Hence a number of investments in global companies have benefited from elevated commodity prices, strong earnings, and the weak Rand. This has been supportive for a number of our key holdings.

The JSE has struggled to generate good Dollar returns for some time. As evidenced by the chart on the left below, the FTSE World Equity index has outperformed the JSE in Dollars by over 30% since the beginning of the year - as bad as the two previous EM crises since the 2008 global financial crisis, which includes the 2015 global "nominal recession" and in South Africa culminated in the infamous events around "Nenegate" in December 2015. More sobering is the chart on the right, which shows that in Dollars, capital returns from either the All Share Index or an "SA inc" index have been flat for over a decade!





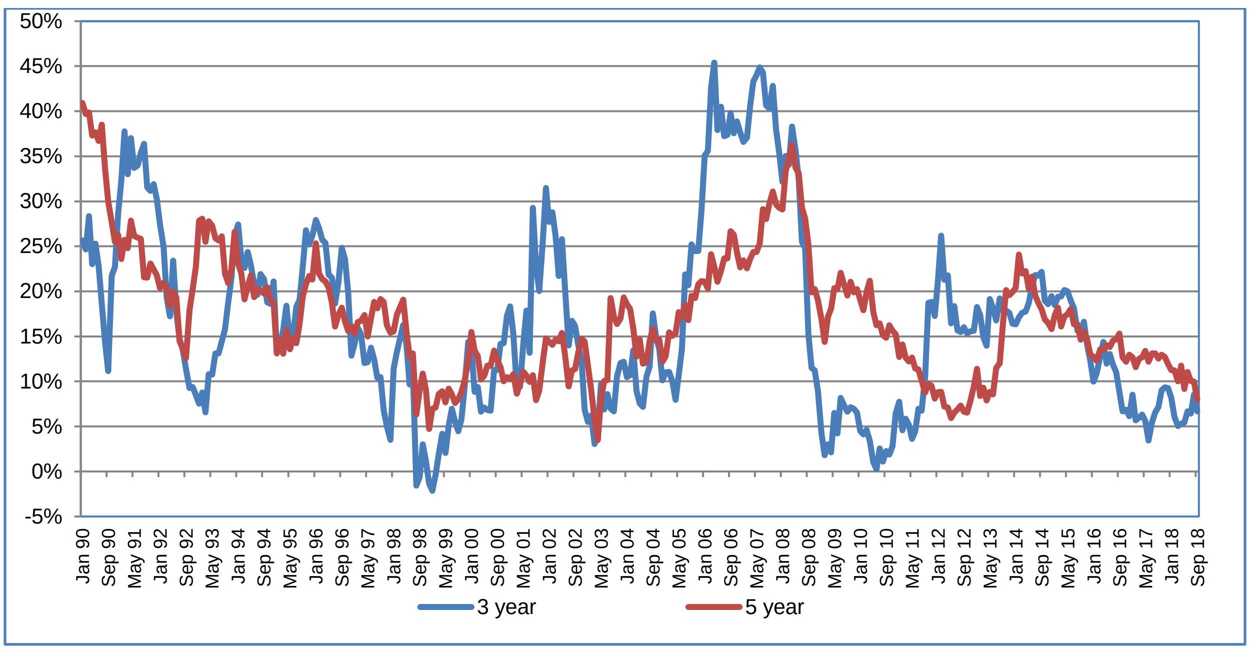
Much of the above has already happened, so whilst it may indeed be interesting, it is what we are doing about it that is ultimately of more relevance.

Market Performance

Returns for domestic equity investors have been disappointing in recent years. Most major indices are down meaningfully since the beginning of the year. Industrials (-12%) and Property (-22%) have borne the brunt of the sell-off. Only the Resources sector (+22%) has delivered positive sector returns so far in 2018. As the summary table below highlights, balanced funds (as measured by the peer group average) have also delivered underwhelming returns, with an outcome which is below inflation over a 3 year period. This is despite the tailwind which an allocation to offshore assets and domestic fixed income assets have provided over the period.

Returns to 30 September 2018	YTD	1 YR	3 YR	5 YR
ALSI	-3.8%	4.4%	7.1%	7.8%
Multi-Asset Peer Group Average (Balanced)	0.6%	2.7%	4.9%	7.2%

The graphic below illustrates the three and five year nominal rolling returns from the JSE since 1990 and it puts the current returns into context. Looking forward, when we consider this historic return profile in conjunction with the current starting point for domestic equity valuations, we are hopeful about the prospect of being able to deliver better returns from domestic equities.



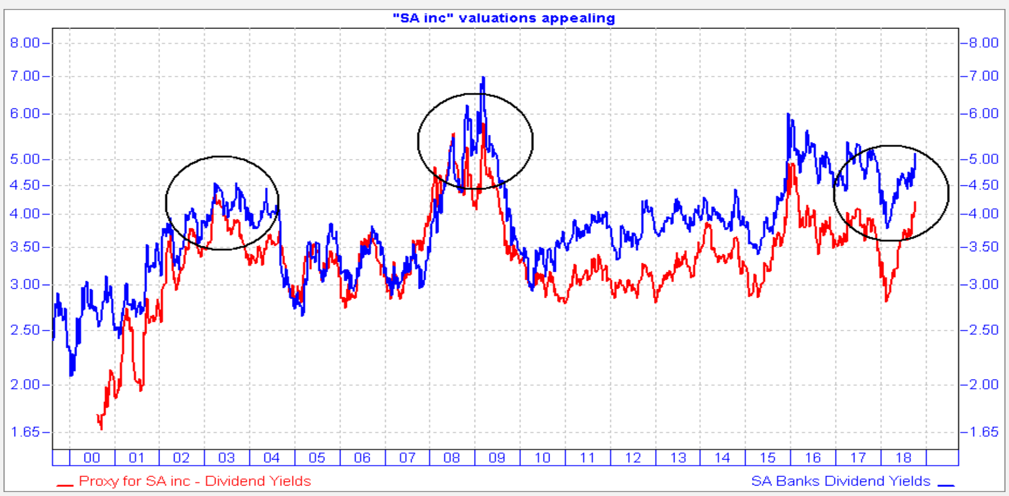
South African Equity Market Implications

In theory, current market conditions should have us salivating at the prospect for future returns – active managers live for environments such as these, when good companies trade at what we would deem to be attractive valuations. In practice, the journey to get to current valuations can be a painful one for investors.

We have held a view for some time that the investment opportunities we have been presented with include a number of attractively valued companies, some of which operate predominantly within the South African economy – the "SA Inc" names as they are often referred to. In our investment process, we refer to the interchangeable dynamic between our bottom-up and top down views. It is clear that the local economy has endured a difficult number of years, and we have already seen the culmination of these issues play out in the slowing earnings bases of many local financial and industrial companies over the last year or so.

Well known global investor, Jeremy Grantham, once said "if stocks are attractive and you don't buy and they run away, you don't just look like an idiot, you are an idiot." Whilst the language may be a little inflammatory, and the extent of attractiveness subjective, the sentiment does resonate. It is not inconceivable that valuations continue to get cheaper, or prospects for earnings decline further, but on the balance of probabilities, and based on our assessment of the economic prospects companies are facing, we believe select equities look increasingly attractive.

Short of going into each investment case, we thought it would be useful to touch on one aspect of valuations to illustrate what we see as the growing opportunity set. The chart below shows the historic dividend yields of the South African banking index, and an average dividend yield of 8 large financial and industrial companies that have been listed for the last 18 years, which we believe form a useful proxy for SA inc. The 3 circles highlight previous periods of distressed valuations, with the previous 2, being 2003 and 2009 proving to be good entry points for investors. Aside from the depths of the global financial crisis, dividend yields today are more elevated than they have been at any point over the last 18 years.



Source: Iress. SA inc proxy is average dividend yield of 8 financial and industrial companies

By way of example and as a further illustration of this point, our calculation of the weighted forward PE multiple of the ClucasGray Equity Fund is currently 11.8, with a dividend yield of 4.3% - we don't recall seeing these portfolio metrics for some time.

The Alpha Thesis we use in our investment process refers to the ability of a company to either grow its earnings base, or enjoy a re-rating – either or both of these factors would drive returns. We believe we are currently in a phase where some valuations are sufficiently suppressed, that not much earnings growth is required for these companies to deliver attractive returns - clearly the timing of any re-rating is always uncertain. This grouping of companies that have undemanding valuations, muted earnings prospects and importantly strong balance sheets has grown in number over the last while, providing patient investors with numerous interesting opportunities.

Outlook

There are certainly some risks building with regards to the outlook for global growth, emanating from a combination of the higher oil price, a strong US Dollar, together with trade tensions and policy responses. Some deceleration in global growth is expected into 2019, but currently growth is still solid and tracking above its long- term average of 3,5%. For now, this backdrop is still largely supportive for earnings growth prospects.

On the domestic front, the news of a stimulus package and the revised mining charter are good signs and provide some direction to an economy where confidence is absent and capital investment is currently "frozen". It is unclear to us whether any specific economic catalyst will ignite the domestic economy and we prefer to focus the majority of our time and effort on assessing the ability of each individual asset within portfolios to be able to deliver returns.

Recent developments have proved disconcerting – a currency crisis brings with it numerous unwarranted complications. We have been here before, and whilst no-one can lay claim to any foresight as to when things improve, by resolutely adhering to our investment process, and actively allocating across asset classes, sectors and underlying companies, we believe we will look back at these times as having provided investors with attractive prices at which to buy good companies.

If there is any interest to engage further, please do not hesitate to get in touch with us.

Kind Regards

The ClucasGray Team

Annexure: Return Table – 30 September 2018

ClucasGray Summary: Source Bloomberg						
Data to:	2018-09-30					
DOMESTIC MARKET	1 Month	Quarter	YTD	1Y	3Y	5Y
JSE All Share TR	-4,2	-2,2	-3,8	3,3	6,7	8,0
JSE SWIX TR	-4,5	-3,3	-8,0	0,9	5,6	8,0
JSE MID CAP INDEX	-4,5	-2,8	-14,6	-5,2	2,0	3,6
JSE Resi TR	0,3	4,6	24,0	28,5	14,4	0,7
JSE Fini TR	-2,0	4,2	-3,8	14,8	6,2	11,4
JSE Indi TR	-8,1	-8,2	-11,8	-7,7	2,8	8,4
Property TR	-2,6	-1,0	-22,2	-15,7	-1,4	6,8

GLOBAL MARKETS (Local Currency)	Month	Quarter	YTD	1Y	3Y	5Y
MSCI All Country WORLD INDEX TR	0,4	4,3	3,8	9,8	13,4	8,7
S&P 500	0,6	7,7	10,6	17,9	17,3	13,9
Nasdaq	-0,8	7,1	16,6	23,9	20,3	16,4
Euro Stoxx 50	0,3	0,4	-0,6	-2,9	5,9	6,1
Shanghai	3,5	-0,9	-14,7	-15,8	-2,6	5,3
FTSE 100	1,2	-0,7	1,0	6,1	11,8	7,1
MSCI Emerging	-0,5	-1,1	-7,7	-0,8	12,4	3,6

Exchange Rates	Month	Quarter	YTD	1Y	3Y	5Y
ZAR/$	3,7	-3,0	-14,2	-4,3	-0,7	-7,1
ZAR/£	3,2	-1,7	-10,2	-1,4	4,2	-2,6
ZAR/€	3,7	-2,4	-10,5	-2,5	-2,0	-3,9
ZAR/AUS $	3,3	-0,5	-5,7	3,8	-1,7	-1,8
ZAR/BRL	3,4	1,2	6,7	18,4	0,1	5,0
$/£	-0,5	1,3	3,6	2,7	4,9	4,2
$/€	0,0	0,7	3,3	1,8	-1,3	3,0
$/CHF	1,3	-0,9	0,7	1,4	0,3	1,6

COMMODITY PRICES	Month	Quarter	YTD	1Y	3Y	5Y
Oil (Brent)	6,9	5,9	30,0	49,3	10,8	-1,4
Copper (3 month LME)	4,7	-5,6	-13,6	-3,4	6,6	-3,0
Platinum	3,7	-4,2	-12,2	-10,5	-3,3	-10,3
Iron Ore	6,5	9,2	-6,7	4,5	4,9	-12,9