4WORD

May 2018

27four Investment Managers
Monthly Market Review

WE LIVE INVESTMENTS. 27four INVESTMENT MANAGERS

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FINANCIAL MARKETS

After a challenging start to the year, local equity markets enjoyed a strong reversal in fortunes during April ending the month firmly higher on the back of the back of a recovery in some of the most beaten down stocks (including the Resillient group of companies, MTN, Woolworths and Capitec) as well as some strong support provided by a notably weaker Rand. The strongest beneficiaries of this included index heavyweights Naspers, Bidcorp and Richemont which all ended the month north of 5% higher with Richemont and Bidcorp ending over 10% higher. Perhaps most disappointingly was performance from highly defensive British American Tobacco which actually ended the month down in excess of 1% despite the weaker Rand. The greatest precipitator of such disappointing performance is concerns from investors globally regarding regulation as well as a drying up of growth given doubts over new generation products such as heat not burn continues to plague such businesses. This was most evident during April when British American Tobacco rival Philip Morris International announced results where shipments of their flagship IQOS new generation heat not burn technology witnessed declines relative to the same reporting period last year and resulted in the strongest one day loss for all major Tobacco companies in a decade. Despite the very strong performance of April, year to date returns remain in negative territory and May thus far has proved to maintain the status quo with regards to volatility beginning to elevate off historically very low levels. In light of the weaker Rand and general risk off trade affecting emerging market assets across the board as political tensions mounted within the US and the 10 year Treasury yield spiked above 3% for the first time in more than 4 years, SA incorporated assets (including the big four banks, retailers and South African bonds) all witnessed material selling pressure.

While it is undeniable that no two businesses are identical and that ultimately better quality businesses at a favourable valuation will always outperform their poorer quality counterparts over a full market cycle, the current market dynamic presents an interesting balance between the beginning of a re-rating for a number of good quality businesses with good quality earnings prospects weighed down by investor sentiments offset with temporary investor vagaries of businesses leveraged to an improving economic backdrop which have perhaps run excessively. Perhaps the best way to illustrate this point would be to consider the performance of both Massmart and AECI since the beginning of December 2017. While Massmart has actually outperformed AECI over this period, it would appear that the latter appears to be a higher quality company. AECI delivered creditable results for the year ended December 2017 growing headline earnings per share by 17%, profits by 21% and dividends by 10%. Perhaps most encouragingly, the group managed to do this at a time of very weak economic growth and subdued activity in the mining and manufacturing sectors which are the primary sources of business for its chemicals and explosives division. On another positive note, all numbers have been produced prior to the purchase and integration of Much Asphalt which would look to diversify the business' earnings stream and generate many synergies to be exploited within the current business. This acquisitive diversification strategy is thought to have come at a fairly hefty price (paying R2.3 billion for Much Asphalt or a 12.3 times earnings ratio for an unlisted business) however with an aggressive strategy of looking to capture some the R328 billion in road and infrastructure spend over the medium term, it would seem fair that credibility be given to management for a successful integration of such an acquisition given the track record of capital allocation within the explosives business as well as frugal cost control driving earnings during a cyclical slump in industries to which they are most exposed (mining and agriculture). While the results announcement was particularly impressive, there was no new material information to be obtained and analysts and the general market were already aware of AECI's flexibility in navigating the business through a highly challenging economic backdrop. Despite this, until evidence of improved economic prospects emerged, a re-rating in the stock and the beginning of unlocking the potential returns eluded the share. When one considers Massmart on the other hand, the investment case and outlook remains considerably more uncertain. Issues which have plagued the business previously continue to exist and with the share price reaction we have seen on the back of a mere expectation of better trading conditions on a forward looking basis, investors continue to be faced with the same ongoing challenges thus impairing the quality assessment of the business with the rating having moved sharply into more unfavourable territory (moving from 20X historic earnings to 24X historic earnings). Some of the challenges which bring into question the ability to capitalise on an improved consumer backdrop include a convoluted strategy with various business units cannibalizing each other resulting in suboptimal allocation of resources, a challenged implementation of the Walmart strategy and culture and a lack of ability to fully leverage the synergies such a transaction might have brought and ineffective stock management and distribution channels costing the business market share and weighing on margins. Ultimately, while the backdrop may be a lot more supportive for the South African consumer which could drive adequate top line growth even with such strategic missteps, it is arguable that this positivity is already materially priced into the asset and thus there is little benefit to be enjoyed by attempting to capture this theme. It is also plausible that this theme played out the most aggressively in Massmart relative to some of the other retailers given the lower starting multiple and a considerable lag in performance relative to these peers over the last 5 years prior to the ANC elective conference. If one considers the 27% collapse in the share price in the 5 year period prior to December 2017 (the worst performing amongst a basket of major retail peers including Truworths, Mr Price, The Foschini Group, Cashbuild, Shoprite, Pick n Pay, Woolworths and Clicks), some context is given as to the starting base and consequent reaction to positive news regarding medium dated macroeconomic headwinds becoming tailwinds. Ultimately, however, the opportunity has been missed and the business is pricing in much optimism whilst remaining a subpar business with regards to quality. It is with this identical lens that the entire subsect of "SA Inc" businesses should be approached given the shifting environment. What is the outlook going forward? Has anything fundamentally changed and finally what price relative to earnings and to a realistic set of assumptions about the future is being paid for such an opportunity? The shifting narrative has been palpable and sectors which remained out of favour for the best part of two years have begun to re-rate aggressively in lieu of improved growth prospects on a forward looking basis. Further evidence of the shifting narrative outside of the large market capitalisation South African incorporated businesses can be found in what is being termed as the first wave of re-rating in a number of mid-cap opportunities. While it is still early days and there remains significant value yet to be unlocked from this segment of the market, one could consider the turnaround in fortunes at companies such as AECI as well as Italtile as clear examples of improving investor sentiment filtering through into interest in companies related in no way apart from size and perception of earnings base.

In lieu of attempting to find a balance within an equity portfolio and having exposure to businesses leveraged to the South African economy, we believe that more attractively valued opportunities can be found in the banking sector. While there has been a notable degree of multiple re-rating in the sector subsequent to the ANC elective conference, absolute valuations remain in check at around 13 times historic earnings with valuations deviating materially within the sector as the likes of Barclays Group Africa trades at under 10X earnings while the higher quality operators Firstrand and Standard Bank trade at multiples of 13X and 15X earnings respectively. While this is a premium to where they have traded in the recent past (with the exception of Barclays Group Africa), recent earnings announcements indicate much better quality businesses with sustainable earnings growth as significant as the mid to high teens and still attractive and growing dividends. In addition to this, the integration of African operations at the likes of Standard Bank and an active effort to capture a greater share of banking revenues in Africa from Barclays Group (with an ambitious target of 12% of banking revenues in Africa), earnings are undoubtedly on an upward trajectory with a fairly high degree of confidence. The greater degree of certainty refers to the outlook for the local economy and the prospects for banking profits to increase in this environment given declining non-performing loans and the contribution of this to banking earnings (expected to be 3.6% contribution to the increase in operating income of banks for the period ended 31 December 2017) and declining interest rates and improving consumer and business confidence driving top line growth through higher credit extension.

While 2018 has seen an increase in volatility, it still remains exceptionally low when compared to history and remains low even when compared to average volatility in the recent bout of exceptionally low volatility stretching back to 2011. While we are likely to witness sporadic patches of volatility spikes as central bank action and political events dominate the headlines, it is unlikely volatility will reach any kind of heightened level when compared to history as policy makers actively seek to avoid that happening given the negative consequence for risk assets and the trickle down impact into the real economy. With all things considered, global equity markets were driven by very strong performance from European equities during May as concerns remain over the sustainability of the Technology rally in the US. With information rapidly becoming the most precious commodity of the 21st century, business practices of Technology companies have increasingly attracted an intense amount of scrutiny and public calls for greater regulation. With the Facebook data breach scandal involving Cambridge Analytica merely being the catalyst to fast track the road to getting there, investors are left somewhat bewildered as to the impact on future profitability given the central thesis of information being harnessed for the effective use of targeted advertising. Facebook's share price reaction to the scandal has been extreme with around $71 billion being wiped off from their market cap in the immediate aftermath of it breaking. To put this into context, this translates into a 13% drop which represents a market value sufficient to buyout Firstrand as well as Standard Bank and still have roughly R120 billion left over. Very strong earnings numbers for the likes of Facebook have done little to allay investor fears as the market begins pricing in the probability of such strong advertising revenues continuing and in the case of Google becoming concerned over the extent of capital expenditure as the company attempts to continue to manufacture earnings growth to warrant an elevated multiple.

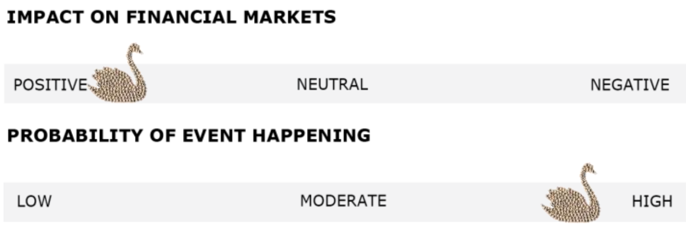
FINANCIAL INDICATORS PERFORMANCE

As at 30 April 2018

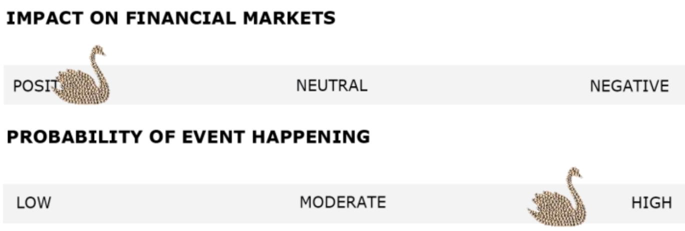
SA INDICES	1 Month	3 Months	6 Months	YTD	1 Year	3 Years (Ann)	5 Years (Ann)
ALSI	5.37%	-1.02%	0.18%	-0.92%	11.42%	5.27%	11.74%
RESI 20	9.22%	2.59%	3.60%	6.33%	21.44%	-1.82%	0.60%
INDI 25	5.79%	-3.67%	-6.53%	-3.46%	6.67%	5.71%	14.70%
FINI 30	4.57%	-2.14%	-2.10%	-2.76%	10.09%	5.79%	14.82%
SAPY	7.68%	-3.91%	-8.06%	-13.43%	-0.45%	2.00%	7.17%
SWIX	4.29%	-2.09%	0.10%	-2.75%	9.66%	4.49%	12.14%
ALBI	-0.70%	5.34%	12.26%	7.30%	13.75%	8.57%	6.71%
STeFI	0.58%	1.74%	3.56%	2.35%	7.43%	7.23%	6.64%
SAGLIB	-3.02%	3.07%	3.27%	0.84%	3.32%	3.45%	4.22%
GLOBAL INDICES							
DOW JONES	0.25%	-7.60%	3.36%	-2.25%	15.39%	10.64%	10.24%
S&P 500	0.19%	-6.22%	2.83%	-0.96%	11.07%	8.29%	10.64%
FTSE 100	6.42%	-0.32%	0.22%	-2.32%	4.24%	2.56%	3.15%
CAC 40	6.84%	0.70%	0.31%	3.91%	4.81%	3.04%	7.44%
DAX 30	3.79%	-3.94%	-3.08%	-1.79%	4.40%	4.96%	10.98%
HANG SENG	2.38%	-6.32%	9.07%	2.97%	25.16%	3.07%	6.26%
NIKKEI 225	4.72%	-2.73%	2.07%	-1.30%	17.04%	4.80%	10.14%
MSCI WORLD	1.21%	-4.99%	3.68%	0.05%	13.84%	8.16%	9.88%
BARCLAYS GLOBAL BOND INDEX	-1.60%	-1.44%	1.20%	-0.26%	4.09%	2.23%	0.89%
CURRENCIES							
GBPUSD	-1.76%	-3.19%	3.58%	1.75%	6.32%	-3.73%	-2.39%
EURUSD	-1.96%	-3.03%	3.66%	0.57%	10.88%	2.80%	-1.71%
USDZAR	5.39%	4.96%	-11.74%	0.69%	-6.73%	1.85%	6.78%
GBPZAR	3.27%	1.57%	-8.62%	2.42%	-0.62%	-1.95%	4.22%
EURZAR	3.18%	1.77%	-8.54%	1.25%	3.35%	4.71%	4.95%
ZARJPY	-2.31%	-4.65%	9.07%	-3.63%	5.11%	-4.43%	-4.13%
COMMODITIES							
GOLD	-0.59%	-1.89%	3.63%	1.59%	3.87%	3.58%	-2.26%
PLATINUM	-2.59%	-9.63%	-1.56%	-2.52%	-4.01%	-7.41%	-9.67%
BRENT CRUDE	7.58%	8.44%	21.97%	12.25%	43.46%	3.85%	-6.12%
SA SECTORS							
RESOURCES	8.55%	1.17%	2.25%	4.39%	19.87%	-1.15%	1.01%
BASIC MATERIALS	8.49%	1.10%	2.18%	4.31%	19.78%	5.44%	5.79%
HEALTH	7.22%	6.96%	-0.56%	5.14%	-1.55%	-9.25%	5.25%
CONSUMER GOODS	6.56%	-3.08%	-20.22%	-1.45%	-14.68%	2.23%	9.75%
CONSUMER SERVICES	4.86%	-5.12%	-2.09%	-5.93%	20.54%	13.95%	25.58%
TELECOMS	4.26%	-1.63%	4.92%	-1.14%	3.33%	-10.83%	3.77%
INDUSTRIALS	3.55%	-3.76%	13.56%	1.78%	17.83%	8.01%	8.99%
FINANCIALS	3.23%	2.61%	12.68%	-0.45%	17.21%	4.34%	13.23%
TECHNOLOGY	-3.95%	-29.47%	-45.75%	-33.23%	-54.06%	-24.61%	-5.62%

TOP 5 THEMES DRIVING ASSET ALLOCATION DECISIONS

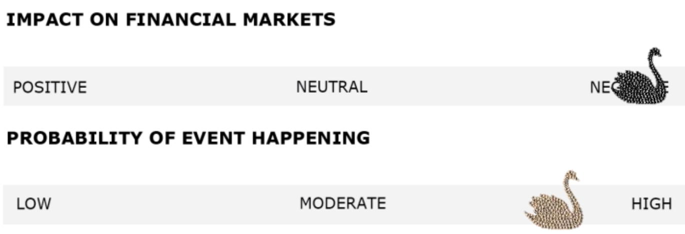
1. **Improving global growth expectations**
With the global economy humming along as evidenced by the strong pick-up in industrial metal prices over the last 6 months, corporate investment is likely to continue to lead earnings growth globally. As the economic expansion continues to gather pace, we are likely to see interest rates being increased in a responsible way which is likely to result in greater efficiency in the allocation of capital into the long term which would ultimately prove to be equity supportive through a higher quality of earnings growth.



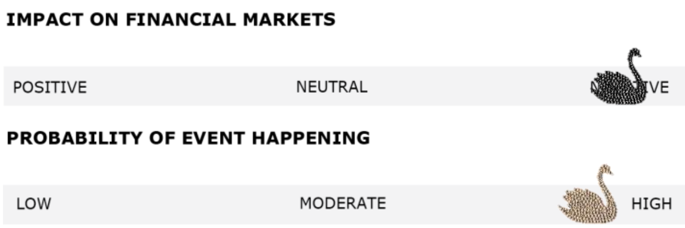
2. **Opportunity set available in global listed property remaining attractive**
With mid-single digit earnings growth pencilled in on a forward looking 12 month basis, the sector continues to reap the benefits of an improving global economy as vacancy rates and rental escalations continue to improve. In addition to material yield spreads relative to equivalent government bonds, the sector continues to trade on around a 10% discount relative to NAV on a composite global basis ensuring that valuations remain prudent whilst earnings growth remains entrenched.



3. **Heightened geo-political risk**
While the economic recovery seems to be gaining traction globally, geopolitics threatens to weigh on confidence and reduce the positive impacts of increased investment, employment and inflation. The greatest threat currently remains the tariffs announced by President Trump and the impacts this may have with regards to retaliation from the rest of the world ultimately escalating into a full blown trade war placing a damper on global growth prospects.



4. **Governance concerns weighing on JSE companies**
Subsequent to the demise of Steinhoff, there has been significant concern from a number of investors on the governance issues plaguing a number of other JSE corporates. With the listed property sector being the latest sector to attract negative scrutiny with disastrous share price performance in this regard, investors are cautioned to be a lot more cognisant of corporate governance, proxy voting issues and being active in



holding management to account in order to prevent such events from destroying value in the future.

5. Increased global inflation

While much has been made of the prospects of increasing inflation and how this would be negative for financial markets given increased interest rates, this argument does not take into consideration the opportunity higher inflation due to higher wages offers to corporates globally. Should consumers be in a position to earn more, corporates are likely to have a greater ability to pass on additional costs onto the consumer thus supporting company margins and cash flows into the longer term. It should be noted, however, that companies that have been poor allocators of capital solely reliant on low interest rates to earn a return greater than their cost of capital remain in a precarious position as a result of increasing interest rates.

How to read this chart:

Impact on financial markets
Black swan: Negative impact
White swan: Positive impact
Red swan: Neutral impact

Probability of event
Black swan: Low probability
White swan: High probability
Red swan: Moderate probability

ASSET ALLOCATION OUTLOOK

Asset Class	Max Underweight	Underweight	Neutral	Overweight	Max Overweight
SA Equity			Previous, Current		
SA Bonds		Current	Previous		
SA Inflation Linked Bonds	Current	Previous			
SA Listed Property		Previous, Current			
SA Cash			Current, Previous		
Offshore Equity				Previous, Current	
Offshore Listed Property					Previous, Current
Offshore Bonds	Current	Previous			

Previous allocation (as of 31 March 2018) Current allocation (as of 30 April 2018)

12 MONTH RISK AND RETURN EXPECTATION

	0% - 2%	2% - 4%	4% - 6%	6% - 8%	8% - 10%	10% - 12%
SA Equity						Return, Risk
SA Cash	Risk			Return		
SA Inflation Linked Bonds			Return			Risk
SA Listed Property					Return	Risk
SA Bonds				Return	Risk	
Offshore Equity						Risk, Return
Offshore Listed Property						Risk, Return
Offshore Bonds	Return				Risk	
	0% - 2%	2% - 4%	4% - 6%	6% - 8%	8% - 10%	10% - 12%

Risk Return