ANCHOR
STRATEGY & ASSET ALLOCATION
4TH QUARTER 2018

EXECUTIVE SUMMARY

Domestically, both equity and bonds have faced significant headwinds this year. The JSE has been impacted by impossible-to-predict big company-specific troubles, with many index heavyweights (Tiger Brands, Aspen, MTN and MediClinic) experiencing precipitous declines, while a c. 50% drop in the Resilient stable of property companies (Nepi, Resilient, Fortress and Greenbay) also weighed on the market. Local economic conditions remain poor following years of maladministration and those companies driven by domestic circumstances are having a tough time. Added to that, global emerging markets (EMs) have experienced a bear market of late, with a notable trigger being the first implementation of US trade tariffs against China. Nevertheless, domestically, we are seeing some green shoots of recovery as the political changes ushered in at the ANC elective conference in December start to take hold. Whilst the direction of change is ever so gradual an improvement, it would be folly for us to ignore the risks of slipping back to the disastrous years of the Zuma presidency. Government faces an uphill battle in turning around the SA economy and setting us on the path towards a sustainable recovery especially in light of the many headwinds both domestically and abroad facing the country. In light of this, we lower our stance from positive to neutral on SA equity and property.

SA bonds remained under pressure into 3Q18. Constant sell-off pressure in the market, driven by heightened negative EM sentiment emanating from events in Turkey and Argentina, which created fears of a contagion effect on other EM economies, continued to weigh on local bonds. The bond sell-off was exacerbated by weakening SA fundamentals as the country entered into a technical recession in 1H18, with concerns of an overshoot in the current account and fiscal deficits. This, and the US adding further tariffs on $200bn of Chinese goods, pushed yields as high as 9.3% in 3Q18 before settling around 9% at quarter-end. However, we think the market has sold off excessively in response to the risks inherent in EMs, creating cheap assets which should correct as capital flows move back into EMs and sentiment normalises. In our view, the risk of a contagion event is limited given the unpegged nature of many EM currencies, stronger EM fundamentals than five years ago and, broadly speaking, better bank regulations. While we are concerned about the slowdown of economic growth rates across EMs, these appear to be fully priced in and we calculate a 12M implied bond return of 10.7%, comprised of 9% interest carry and 1.7% capital gains. We thus retain our neutral stance on domestic bonds.

With very strong earnings growth (driven by the US) and reasonable valuations, we believe a total return in-line with historical averages is likely for global equities and we project a 12-month return of 8% in US dollar terms. During 2018, US earnings have risen c. 25%, while the market has only risen by 9% - hence the market is around 15% cheaper. This strong growth has enabled the US Federal Reserve (Fed) to continue on its well signalled gradual increase in rates, without disrupting confidence levels. In addition, the current bull market has been sustained with inflation remaining subdued. Outside of the US, performances have been more muted, with the MSCI World Index up 3.8% YTD. While Europe has its challenges, the poor performance of the past 18 months has seen multiples reduce to attractive levels, supporting our forward projection of reasonable returns. Europe has been weighed down by political risk and trade war fears, while Brexit also remains in focus as the deadline for when the UK will leave the EU draws closer with no deal yet. We maintain our neutral stance on global equity.

US 10-year bonds are trading c. 0.1% below our fair yield and we think the total return for the next 12 months is likely to be around 2.2% in US dollar terms. Credit spreads for US investment grade corporate bonds have come off significantly since their January lows (0.9%) and seem fair around the current level of 1.1%. As such, US investment grade corporate bonds should deliver US dollar returns of c. 3.2% over the next twelve months. We also retain a neutral weighting on global bonds.

After reviewing the fundamentals supporting our general asset-class decisions, this report will also focus on a few specific themes. These include trade wars and the potential impact on US inflation (including the knock-on effect this may have on US rates), as well as specific offshore (Accenture Plc and Southwest Airlines) and local (KAP Industrial Holdings) company notes. Finally, we reflect on our earliest money memories and look at tax efficiency in investing.

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01 ASSET ALLOCATION

The following table illustrates our house view on different asset classes. This view is based on our estimate of the risk and return properties of each asset class in question. As individual Anchor portfolios have specific strategies and distinct risk profiles, they may differ from the more generic house view illustrated here.

ASSET CLASS	CURRENT STANCE			EXPECTED RETURNS (ZAR)	
	Neg.	N	Pos.		
LOCAL					BM=80%
Equity			←	14.0%	N
Bonds				10.7%	N
Property			←	12.0%	N
Cash				6.8%	N
GLOBAL					BM=20%
Equity				2.4%	N
Government bonds				-2.7%	N
Corporate credit				-1.8%	N
Property				-0.8%	N
Cash				-3.9%	N

Neg. = Negative; N = Neutral; Pos. = Positive

02 STRATEGY AND ASSET ALLOCATION

Overview

Global growth in aggregate remains robust, but patterns are no longer synchronised as we have been discussing in the past. While the fiscally boosted US expansion goes on, growth in Europe and Japan has peaked and China is relying on renewed stimulus to manage the slowdown of its economic growth. The decoupling of growth rates has manifested in part as currency volatility, with the US dollar trading within a wider-than-normal range against the euro. The dollar remains slightly overvalued against its historic fair value of $1.20/EUR1, however, we think that this is fair in the current growth environment. Our base-case scenario is that global growth will remain intact, albeit at a slower pace. We expect that the effects of the US fiscal stimulus will start to wane, and that US growth will slow towards its historic trend of c. 2.0% by 2020.

Tighter dollar liquidity and higher oil prices have set the backdrop for a challenging environment for EMs. The Trump administration's aggressive protectionist policies (especially concerning tariffs targeting China) are also likely to persist, although we are relieved to see some movement towards finalising the revised North American Free Trade Agreement (NAFTA) with Canada and Mexico. This backdrop, along with less robust economic growth rates, will remain headwinds for EMs.

Domestically, we see some green shoots of recovery. It is increasingly clear that the political changes ushered in at the ANC elective conference last year are beginning to take hold. Nevertheless, these seeds of change are still frail and have barely begun to take root. Whilst the direction of change is ever so gradual an improvement, it would be folly for us to ignore the risks of slipping back to the disastrous years of the Jacob Zuma presidency.

The fledgling recovery against a difficult global backdrop will see local economic growth under pressure for some time still. Baby steps towards an improving business environment have been taken and we are hopeful that, in time, giant strides towards a more flexible labour market, an embracing of the corporate sector, a competitive education system and government service delivery will set us firmly on the path towards a sustainable recovery.

South African equities

We are moderately positive about returns from the local equity market over the next 12 months, with some optionality to the upside. Our projected 12-month total return (including dividends) is 14%. This is consistent with a neutral stance on the asset class.

Thus far, 2018 has been influenced more by big share-specific disasters than the overall market (which also did not help). It is difficult to recall a period where so many index heavyweights experienced such precipitous declines. Among 2018's FTSE JSE Top-40 Index decliners (for the calendar year to date) are Tiger Brands (-42%), NEPI Rockcastle (-40%), Aspen (-39%), MTN (-36%) and MediClinic (-25%). Most of these declines had little to do with the poor state of the South African (SA) economy but were company specific troubles. Many were impossible to predict and once again reminds us of the benefits of a diversified portfolio.

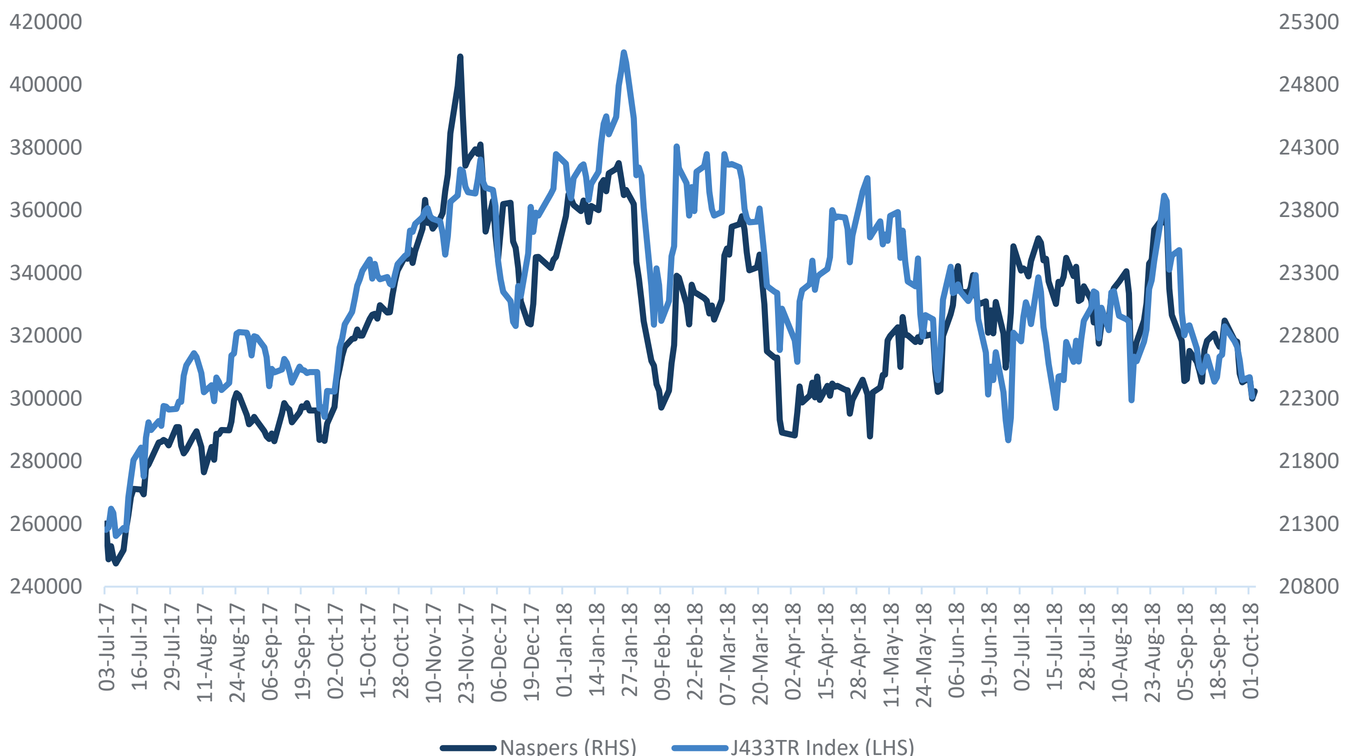
These shares contributed to a disappointing JSE All Share Index total return YTD of a negative 3.8%, with resources being the best-performing sector and Naspers accounting for half the loss. The c. 50% decline in the Resilient property stable (Nepi, Resilient, Fortress and Greenbay) also contributed to more than a 1% weighted loss in the index. The more representative JSE Capped Swix Index, which we use as our benchmark, has declined by 7.4% YTD.

On the assumption that there are no more unexpected negative surprises like those described above, we identify two primary drivers for the market over a 12-month time horizon – global EM sentiment and local economic conditions. In the broadest terms – an EM risk-on scenario is positive for SA equities.

Global EMs have experienced a bear market of late, with a significant trigger being the first implementation of US trade tariffs against China. We believe EMs are now pricing in a fairly negative outcome and valuations are at very attractive levels. There is reasonable potential for a bounce in EMs over the next 12 months which should result in fund flows re-igniting, which generally has a positive impact on the local market.

The best illustration of this is Naspers (see Figure 1 below), which is closely tied to the fortunes of Chinese technology bellwether, Tencent. Naspers is also a major driver of SA market returns (it accounts for c. 20% of the All Share Index and just less than 10% of the JSE Capped SWIX). There is also an extremely strong relationship between Naspers and the SA market over the last 18 months and for many time periods it has been a case of "what Naspers does, the market does". We have a positive view of Naspers.

Figure 1: Naspers share price performance (ZAc) vs Capped SWIX All Share Index



Source: Bloomberg, Anchor

Local economic conditions are poor and companies that are driven by domestic circumstances are having a tough time. In many industries volumes are flat to down and businesses are finding it difficult to pass on cost increases. We believe the market is largely pricing in current conditions, but we also expect to see a number of negative earnings surprises from companies that are seeing their margins being squeezed. Hence, we are placing a great deal of emphasis on bottom-up stock selection and avoiding poorer quality or vulnerable companies and industries.

The key question for domestic companies is whether the economy has bottomed. We do anticipate that the country will bounce back from the current technical recession, but the timing of this is uncertain. Once the economy starts to gain traction there is material upside potential for certain domestic counters that are trading at low multiples on a low earnings base. The SA Inc. basket of companies (e.g. ABSA Holdings, Imperial and Standard Bank) is trading at a PE multiple of around 10x, which is low in historic terms. We could very well experience this positive bounce in the next 12 months and this will provide a great opportunity for equities.

On balance, we expect SA earnings growth of close to 10% (there are a number of earnings drivers other than domestic GDP) over the next 12 months. While there is the potential for a meaningful re-rating, we have only factored in a marginal re-rating in arriving at our 14% projected equity return. However, there is a risk that this takes longer than expected to materialise.

South African bonds

The headwinds faced by SA bonds continued into 3Q18 with constant sell-off pressure in the market. This was largely driven by the heightened negative EM sentiment, which emanated from events in Turkey and Argentina. The most prominent of these events was the arrest of a US pastor in Turkey and the failure by Turkish policymakers to hike interest rates at a time when most expected an increase. This led to a drastic fall in the Turkish lira which created fears of a possible contagion effect on other EM economies. We therefore saw SA bonds sell off by 32 bps as 10-year bond yield moved from 8.7% to 9%.

The sell-off was exacerbated by weakening SA fundamentals as the country entered into a technical recession in 1H18, with concerns of a possible overshoot in the current account and fiscal deficits. This, and the US adding further tariffs on $200bn of Chinese goods, pushed yields as high as 9.3% in 3Q18 before settling around 9% at the quarter-end.

We, however, continue with the narrative that the market has sold off excessively in response to the risks inherent in EMs, creating cheap assets. This should correct as capital flows move back into EMs and sentiment normalises. In particular, the risk of a contagion event is limited given the unpegged nature of many EM currencies, stronger EM fundamentals than five years ago and, broadly speaking, better bank regulations. We are concerned about the slowdown of economic growth rates across EMs, though these appear to be fully priced in.

Weak SA fundamentals and the possibility of an end to the European Central Bank (ECB) monetary stimulus, which will further tighten global monetary conditions, has led us to reassess and adjust our fair valuation of SA bonds. Looking at our fundamental model, we have assumed a fair estimate of the US' 10-year bond yield at 3.2%. We further assumed SA inflation will average 5.8% over the next 12 months, while US inflation averages 2.3%, giving an inflation differential of 3.5%. We use a fair credit default swap (CDS) spread of 2%. Aggregating the US bond yield, the inflation differential and the CDS spread we get a modelled fair yield of 8.7% for SA bonds.

This gives a 12-month implied bond return of 10.7%, comprised of 9% interest carry and 1.7% capital gains.

South African listed property

In 3Q18, the listed property sector was relatively stable and the "bloodletting" that occurred in the first six months of the year was to some extent stemmed. However, it was not immune to the negative newsflow and sentiment that prevailed in the SA domestic market and the EM complex overall. The sector returned -1%, and is showing a negative return of 22.2% for CY18 to date.

The sharp de-rating in the sector has meant that dividend yields available on property stocks have not been seen for some time (in fact not since pre-global financial crisis [GFC] and the brief periods during the taper tantrums of 2013 and the firing of Finance Minister Nhlanhla Nene by ex-President Zuma in late 2015).

The higher dividend yields are, in part, a result of the fundamentals in the sector, which have deteriorated markedly as tenant businesses have faced revenue and margin pressures. New and renewable leases are the subject of negotiations where the landlord is increasingly forced to make concessions.

This has resulted in large bellwether property companies toning down growth forecasts and having to look offshore for growth markets. By way of an example, Growthpoint reported FY18 distribution growth of 6.5% YoY, with FY19 growth guidance reduced to 4.5% YoY. This would become Growthpoint's lowest distribution growth for the last 11 years.

On top of these business factors, land expropriation without compensation (EWC) has received significant headline press at the same time that SA has been pulled into EM issues. Although we believe common sense will prevail, until there is some clarity from the ANC on the issue a positive re-rating is unlikely.

The yield underpin still makes the sector a solid investment destination for the longer-term investor. Assuming no re-rating to the current income levels of c. 9.5% and taking a sensible haircut on growth projections, we forecast a return of approximately 12% for the next 12 months. Accordingly, we have softened our stance on the asset class to neutral.

The rand

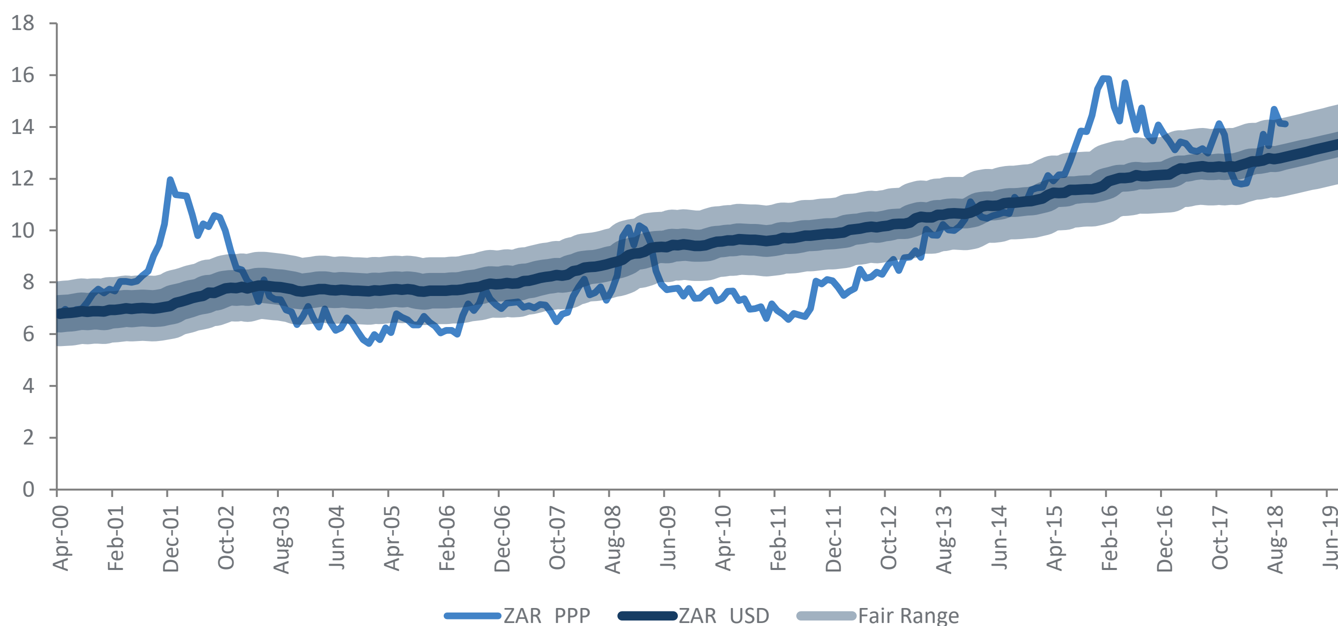
Projecting the rand's value in a year's time is a fool's errand. The rand vs US dollar exchange rate is one of the world's most volatile currency pairs and trades well away from any modelled fair value for long periods of time. We note, however, that the rand trades within a R2.50 range to the dollar in most 12-month periods.

We retain our purchasing power parity (PPP) based model for estimating the fair value of the rand and we have merely extended this out by three months since our last publication. Our PPP-modelled value for the rand vs US dollar at the end of the next 12 months is R13.40/$1. We apply a R2.00 range around this to get a fair value range of R12.40-R14.40/$1.

In the context of a challenging EM scenario, we would realistically expect the rand to be closer to the top of the range right now and, as the global EM backdrop improves, we could see the rand recover further towards the middle of the range.

We note that the rand ended 3Q18 at R14.10/$1, which is actually within our fair-value range. Therefore, whilst we are positive on the prospects of the rand to recover further, the movements might well be muted until we see a dramatic improvement in global EM sentiment. For modelling purposes, we have used the R13.40/$1 midpoint of our range.

Figure 2: Actual ZAR/$ vs ZAR PPP Model



Source: Anchor, Thomson Reuters

Global equity

With very strong earnings growth (driven by the US) and reasonable valuations, we believe a total return in-line with historical averages is the likely outcome for global equities and we project a 12-month return of 8% in US dollar terms.

Markets are ultimately driven by earnings and we are currently experiencing one of the strongest earnings growth phases in US markets ever (driven by 10% turnover growth and lower taxes). On the US company front, FactSet data show that 2Q18 S&P 500 earnings rose 25% YoY with c. 78% of company results topping analyst expectations. Figure 3 below shows that the 12-month forward PE for the All World Index is now 14.6x.

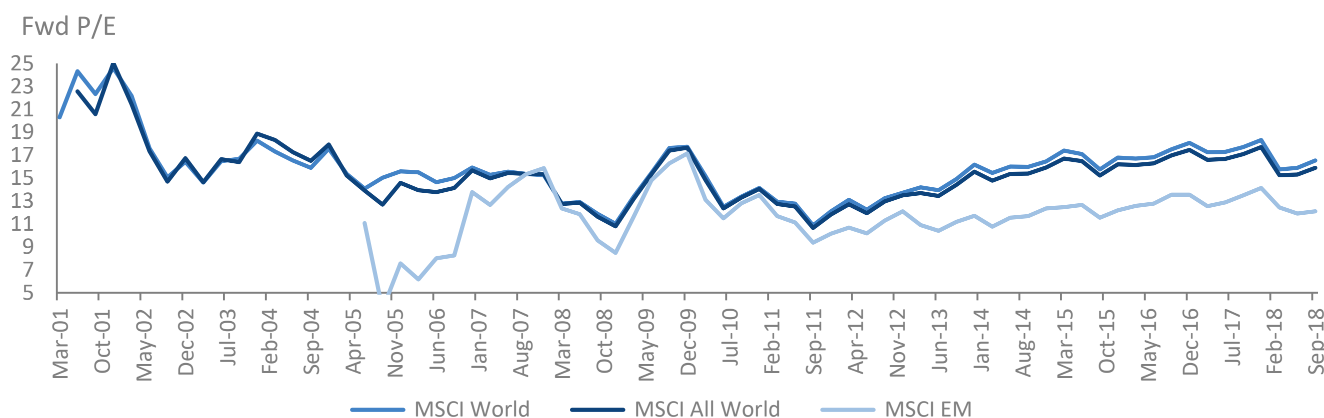
Figure 3: Global earnings, growth and multiple expectations

	EARNINGS GROWTH			P/E	
NAME	YR1	YR2	CURRENT	YR1	YR2
MSCI World Index	19.2%	6.5%	18.1	15.2	14.2
MSCI EM Index	11.0%	12.6%	12.3	11.1	9.8
MSCI All World Index (10% EM)	18.0%	6.1%	17.2	14.6	13.8

Source: Bloomberg consensus

As the chart below indicates, this places the forward PE multiple at around the average of the last 20 years.

Figure 4: MSCI indices fwd PEs



Source: Bloomberg consensus

The market, however, prices in the current and discounts the future. Importantly, as shown in Figure 4 above, earnings expectations two years out are only c. 6%, which is low in historic terms and is not overly optimistic. The multiple seems appropriate for a market with normalised growth.

During 2018, US earnings have risen by 25%, while the market has only risen by 9% - hence the market is around 15% cheaper. This strong growth has enabled the US Fed to continue on its well signalled gradual increase in rates, without disrupting confidence levels. In addition, the current bull market has been sustained with inflation remaining subdued.

The discussion thus far has focused on the US, which is 55% of the world's market capitalisation. The S&P 500 is up 9% YTD and the Nasdaq 16.6% YTD. Outside of the US market, performance has been far more muted, with the MSCI World Index up 3.8% YTD.

While Europe has its challenges, the poor performance of the past 18 months has seen multiples reduce to attractive levels and this supports our forward projection of reasonable returns. Europe has been weighed down by political turmoil as Italy's new populist government proposed a 2019 budget with a far wider deficit than the previous administration's target, setting it on a collision course with the European Union (EU). Germany's Dax is -5.2% YTD, France's CAC is up 3.4% YTD and the UK FTSE 100 is down 2.3% YTD. Brexit also remains in focus as the deadline for when the UK will leave the EU draws closer with Prime Minister Theresa May yet to secure an EU deal. The Japanese Nikkei is 6% higher for the year.

EMs are more perplexing but offer plenty of upside optionality if earnings growth can be sustained. It must be noted that EMs comprise only 10% of the All World Index and are thus less important when projecting a global equity return. *Bloomberg* consensus is for 11%-13% earnings growth for the next two years, with an attractive forward PE multiple of 11x. However, this is not materially below the 20-year average.

The implementation of Trump's first phase of trade tariffs marked the start of a bear market in EMs and any positive resolution could spark a rebound, with bad news probably priced-in. We also expect a round of Chinese stimulus to have a positive impact.

The Hong Kong Hang Seng Index is down 7.1% YTD, while the Shanghai Composite has lost 14.7% YTD. On the economic data front, manufacturing as well as domestic and export demand data showed that China's economy was losing steam as its trade conflict with the US intensified - the private Caixin/ Markit factory Purchasing Managers' Index (PMI) fell to 50.0 in September - its lowest reading since May 2017.

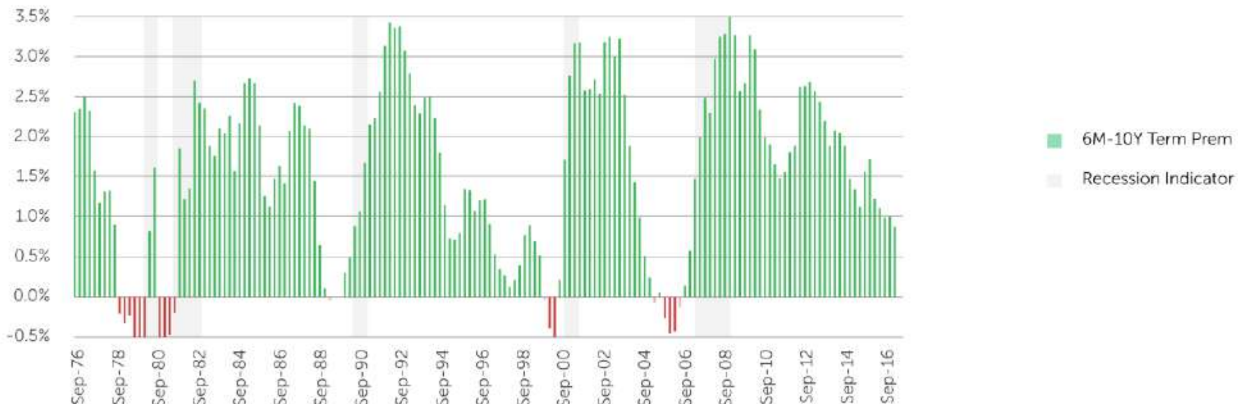
Global bonds

US 10-year bond yields ended 3Q18 above 3%, having failed to stay above that level during three other brief attempts this year. Prior to 2018, the last time US 10-year bond yields managed to edge above 3% was during the 2013 taper tantrum when former Fed Chairman Ben Bernanke announced the Fed's intention to start tapering its quantitative easing (QE) programme. The Fed is firmly in rate-hiking mode, having increased interest rates eight times since the first hike of this cycle in December 2015 (including 3 hikes this year). Market participants currently see a 70% chance of another hike in 2018 and a 50% chance of another 2 hikes next year - that's more dovish than the median Fed member who expects rates to be raised once more this year and three times next year. One hike this year and two in 2019 seem most likely to us, leaving the US federal funds rate at 2.875% by the end of 2019.

We think that US 10-year bond yields are approaching fair value at around 3.2%, with risks to the upside if robust economic growth allows European and Japanese central banks to unwind their QE programmes faster than expected and risks to the downside as spreads between short-term and long-term rates (term premium) compress as and when the current economic cycle runs out of steam.

We get to our fair value by estimating 10-year rates from two directions, first looking at the likely path of Fed rates over the next few months and adding a term premium we believe to be appropriate for this part of the cycle. We think a term premium of 0.8% is appropriate, although this can compress fairly quickly if global growth slows faster than expected.

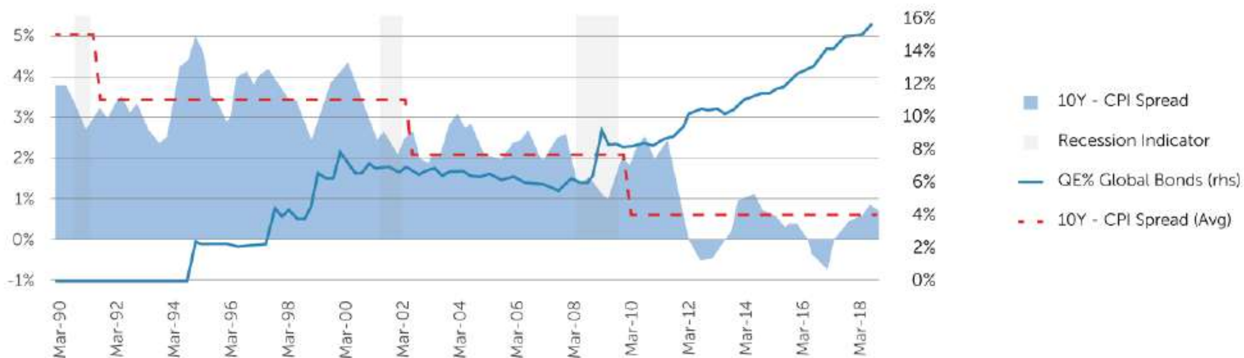
Figure 5: US 10-year bond term premium



Source: Bloomberg, Anchor

Our second approach is to look at the likely path of inflation over the next few months and add a spread that equates to the above inflation (real) return which investors typically demand to own US 10-year government bonds. This spread has been coming down over the last couple of US economic cycles and seems somewhat susceptible to a rapid unwind of global QE, but we put that as a low probability event.

Figure 6: US 10-year bond real return



Source: Bloomberg, Anchor

With US 10-year bonds about 0.1% below our fair value, we think the total return for the next 12 months in US 10-year bonds is likely to be around 2.2% in US dollar terms. Credit spreads for US investment grade corporate bonds have come significantly off their January lows (0.85%) and seem fair around the current level of 1.1%. As such, US investment grade corporate bonds should deliver US dollar returns of around 3.2% over the next twelve months.

Global property

Retail real estate investment trusts (REITs) are the biggest sub-sector within global REIT indices and it's been a space heavily in flux (particularly in the US) as oversupply coincided with structural shifts to online spending. US retail REITs are down about 17% in aggregate over the past two years and now offer a 5% forward yield in US dollar terms (vs. 3.5% two years ago). While the yield now appears attractive, the growth profile, which has been heavily dependent on development and transactions, is somewhat uncertain as is the equilibrium level for online vs offline spending habits. In contrast, the next biggest sector - US residential property, has recently rallied having seemingly digested the oversupply that came online in the US over the last couple of years.

Forward dividend yields have remained stable YTD at around 4.1% despite a 0.7% increase in US 10-year bond yields. Although we believe bond yields may settle around these levels, we think that dividend yields probably need to de-rate about 0.2% to catch up.

Figure 7: Global REIT dividend yields relative to US 10-year bond yields

Source: Bloomberg, Anchor

Growth is the other key driver of REIT total returns and we seem to be through the worst of the slump in growth rates (largely because of retail REITs).

Figure 8: Global REIT dividend yields relative to US 10-year bond yields

Source: Bloomberg, Anchor

In global developed market REITs, we think we could see dividend growth of around 5% over the next twelve months, combined with an average dividend yield of c. 4.2% and a 5% de-rating (as yields go from 4.1% to 4.3%) delivering a total return in US dollar terms of 4.2%.

03 EXPECTED RETURNS ON UNDERLYING ASSETS

The table below summarises our return estimates for the major asset classes.

ASSET CLASS							
EQUITY	PE1	E2 g%	EXIT PE	DIV %	RETURN	ZAR	ZAR RETURN
Local Equity	16.9	10.0%	17.0	3.4%	14.0%	-	14.0%
Global Equity	15.2	6.9%	14.9	2.6%	7.4%	-5.0%	2.4%
Developed Markets	15.9	7.0%	15.7	2.5%	8.0%	-5.0%	3.0%
Emerging Markets	13.1	6.5%	12.7	2.9%	5.7%	-5.0%	0.7%
BONDS, PROPERTY AND CASH			YIELD	CAPITAL	LC RETURN	ZAR	ZAR RETURN
Bonds							
Local Government Bonds			9.0%	1.7%	10.7%	-	10.7%
Global Government Bonds			3.1%	-0.9%	2.2%	-5.0%	-2.7%
Global Corporate Credit			4.2%	-1.0%	3.2%	-5.0%	-1.8%
Property							
Local Property			9.5%	2.5%	12.0%	-	12.0%
Global Property			4.2%	0.0%	4.2%	-5.0%	-0.8%
Cash							
Local			6.8%	0.0%	6.8%	-	6.8%
Global			1.1%	0.0%	1.1%	-5.0%	-3.9%

Note: Sector weightings are by Market Capitalisation; Global Equity benchmark is MSCI World; "PE1" is 12 month forward PE; "E2 g%" is our estimate of earnings growth over the 12 month period, commencing in 12 months time; "exit PE" is our estimate of the PE multiple in 24 months time; "Div %" is our estimate of the dividend yield over the next 12 months; "Return" is our return estimate, over the next 12 months, implied in the tables assumptions about earnings growth, dividends and changes in PE multiples; global markets are estimated in USD, local markets in ZAR; "ZAR" is the currency effect of translating into ZAR; "ZAR Return" is our estimate of ZAR market returns over the next 12 months as implied in the other columns of this table. Benchmark SA bonds are the South African 10 year government bond; The Benchmark Offshore Bonds are the US 10 Year Government Bond, and the Bloomberg Global Investment Grade Corporate Bond Index; The Local Property benchmark is the JSAPY Index; Offshore Property is the S&P Global REIT Index. "Capital " is our estimate of the capital appreciation or depreciation of an instrument over the next 12 months; "LC Return " is our estimate of the total return, i.e. yield + capital, that the instrument will generate over the next 12 months in its local currency; "ZAR" is our estimate of the currency effect of translating non-ZAR yields into ZAR; "ZAR return" is our estimate of the "LC Return" in ZAR.

04

ANCHOR INSIGHTS

In this section, staff from across Anchor provide insights into our thinking, strategy and our view of the world. In this quarter: Peter Little discusses the current trade war between the US and China and its potential impact on US inflation (as well as the knock-on effect this may have on US rates); Liam Hechter analyses Accenture Plc's impressive performance over the past decade; David Gibb writes about the first of the low-cost airlines, Southwest Airlines; Henry Biddlecombe reviews KAP Industrial Holdings; Tamzin Nel explores her earliest money memories and, lastly, Sandy van der Zanden looks at the role of tax efficiency in investing.

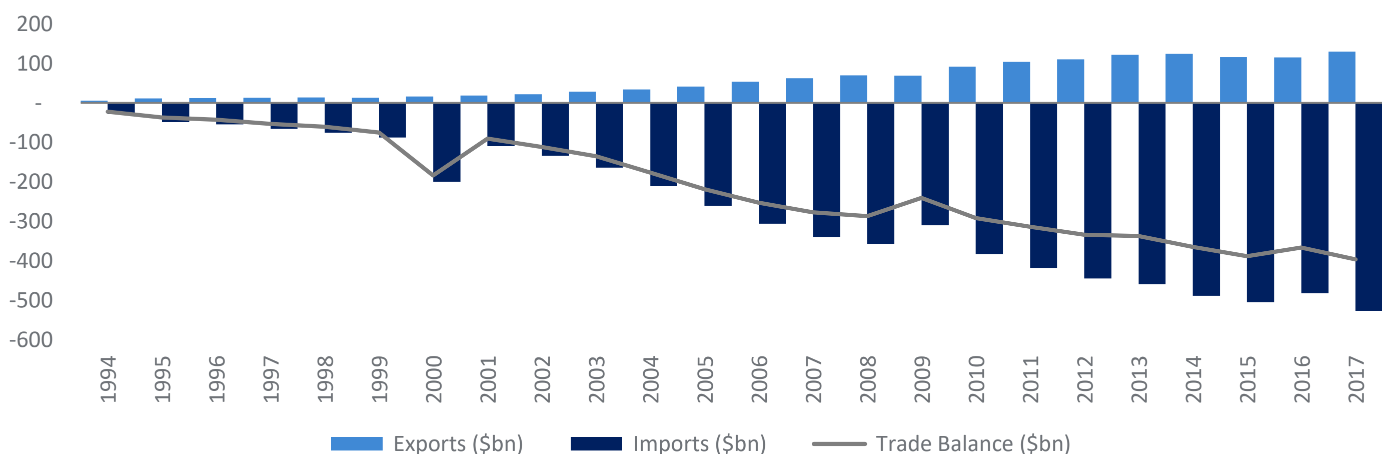
TRADE WARS AND INFLATION

Peter Little
Fund Management

Fear around the impact of trade war has dominated headlines in 3Q18 with US President Donald Trump making it his mission to use the US' massive import bill (in 2017 the US spent $2.9trn on imports) as leverage to renegotiate its relationships with major trading partners. This has unnerved markets and left economists scrambling to calculate the potential economic impact. While much has been written about the potential of trade wars to derail the current robust economic growth environment, the focus of this article is on the potential impact on US inflation and the knock-on effect this may have on US rates (a key driver of most investment values).

The US has a particularly skewed trading relationship with China – in 2017 the country imported goods worth around $526bn from China, while China imported only $130bn of US goods. Trump has implemented tariffs on Chinese imports as punishment for what he believes are unfair trade practices related to theft of US intellectual property.

Figure 1: US trade with China



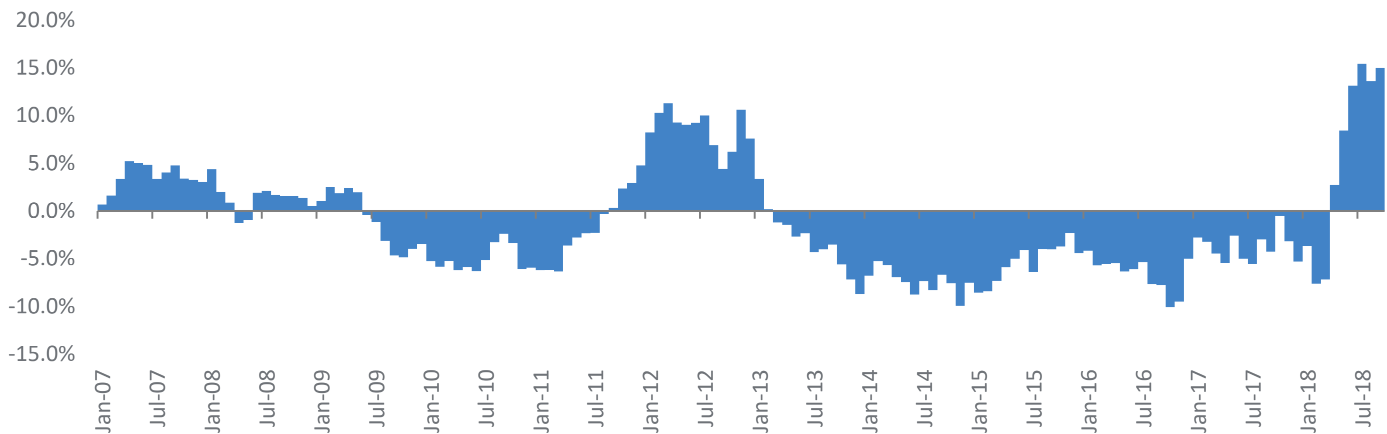
Source: Bloomberg, Anchor

Since July 2018, the US has imposed import tariffs on almost half of Chinese imports ($250bn) and by January 2019 the US will be taxing Chinese importers 25% on the value of these imported goods. There is also the threat to expand tariffs to include all of the approximately $536bn in Chinese imports. If we were to assume that these tariffs are all passed on to the US consumers in the form of higher-priced goods, then that could have consequences for US inflation. US consumers spent around $13.9trn in 2017, so if the US were to end up levying 25% tariffs on all Chinese imports, that would add around 1% to the US consumption bill each year in the form of price inflation. The US Fed's preferred measure of US inflation is currently around its 2% target, so if tariffs were to add 1% to that it's likely the Fed would need to start aggressively hiking interest rates, which usually ends badly for the global economy. We think there are three reasons to believe that the outcome is unlikely to be that extreme.

a) There is evidence to suggest that the full impact of tariffs won't be passed on to consumers.

ECB board member Benoît Cœuré discussed the consequences of protectionism in a recent speech, saying that "Although import prices would likely rise as a result of the increase in tariffs ... consumer price inflation and wage growth are likely to decelerate as the effects of lower aggregate demand and higher unemployment can be expected to prevail, both in the United States and globally." There is also a good recent example of what happens to prices of US goods affected by tariffs. On 22 January 2018, the US imposed a 20% tariff on the first 1.2mn imported washing machines and a 50% tariff on imports above that number. Fortunately for us the US publishes data on washing machine inflation, which we saw spike to around 15% in the months that followed the tariffs (lower than the level of the tariffs).

Figure 2: US laundry equipment inflation:

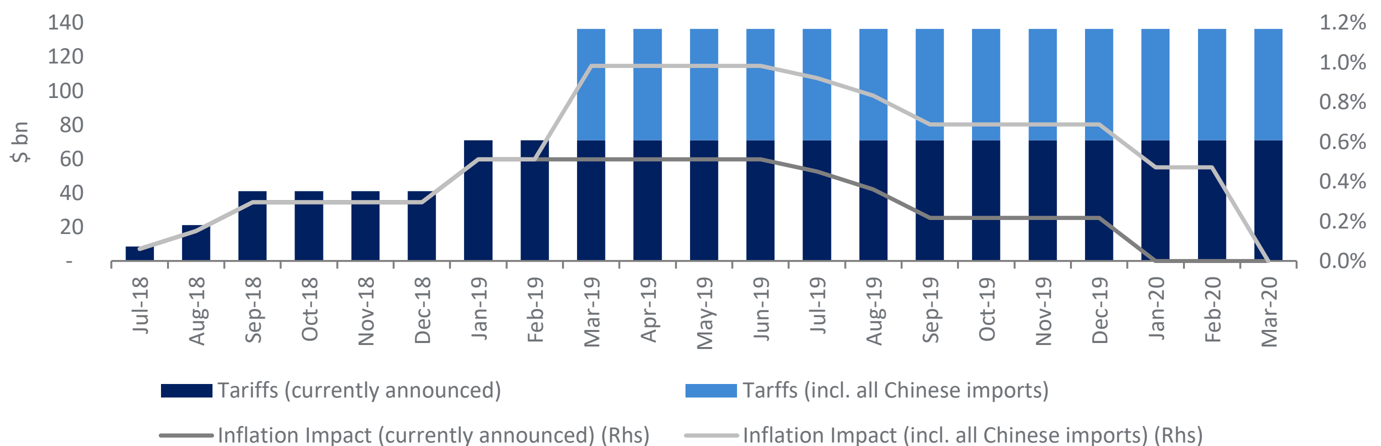


Source: Bloomberg, Anchor

b) The impact of tariffs on inflation will be transitory and the staggered implementation will further dilute the impact.

A once-off shock in prices has a transitory impact on inflation which is measured relative to prices a year earlier so, once the prices have been higher for over a year, they no longer result in inflation. That combined with the fact that the implementation of the tariffs has been staggered over the course of about six months for the initially enacted tariffs (and potentially even longer if additional Chinese imports are subjected to tariffs) will mean that the impact will likely be stretched over a period of around two years, diluting the impact in any single period. The chart below shows our estimate of the impact on US inflation under the two different scenarios: a) no additional goods subject to tariffs, b) tariffs expanded to include all Chinese imports.

Figure 3: Impact of Chinese tariffs:



Source: Bloomberg, Anchor

These calculations also assume 100% pass-through of tariffs to consumer prices, which we've already noted above we believe is unlikely.

c) We're hopeful that some sanity will prevail and the US will not expand tariffs to include all Chinese imports.

Trump has been a bit like a bull in a china shop (pun intended) when it comes to international relations, so there is clearly a possibility that he follows through on his threat to expand tariffs to all Chinese imports. However, we're hopeful that might not be the case and, even if it does happen, that it won't be at the 25% level currently in effect (perhaps only 10%). Its likely that the tariffs already cover goods the US has cherry-picked to have the least impact on US companies and it will become increasingly difficult to insulate Americans and their companies as more goods get added to the tariff lists.

So, while we do think the trade tariffs imposed on Chinese imports will cause some inflation in the US, we believe that the Fed is unlikely to respond with additional rate hikes (over and above the hikes we are already expecting), primarily due to the transitory nature of the inflation, but also likely due to the muted impact that will be seen in the data.

ACCENTURE PLC: DECADES LONG INDULGENCE

Liam Hechter
Fund Management

Accenture Plc (ACN_US) is a phenomenal business which has eye-watering financial metrics and an excellent track record. This is, justifiably, reflected in a share price which has doubled in the last four years. With a compound return of 19% p.a., this is well ahead of earnings growth of 12% p.a. We expect the business to continue to grow meaningfully (+/- 9-10% p.a.) but it is unlikely that the share price will maintain historic compound growth rates given the extent of the re-rating that has already taken place. The potential for future operating margin growth is less than what has been achieved historically. Developed markets (DMs) have been in a momentum phase where increasingly high multiples have been attributed to growth businesses. This has seen Accenture re-rate to a forward 23x PE multiple and 1.7% dividend yield, which represents a 50% premium to the overall market. The share appears to be priced for perfection and any misstep in execution could be costly for the share price. Assuming a solid earnings outlook, annual share price performance is likely to be closer to earnings growth of 9%-10%, with the risk of a de-rating when the market becomes more circumspect about the valuations ascribed to growth shares.

Accenture Plc traces its roots back to the days of Arthur Anderson when Anderson Consulting, an IT-focussed consulting agency, spun out from the greater Anderson business. The consulting arm focused primarily on consulting on the information technology (IT) needs of their clients as the 4th industrial revolution, or “IT age”, started gaining traction and IT integration became a way of staying relevant for companies at a minimum. Every business needed to incorporate IT in some way or another to stay relevant and Anderson Consulting was there to assist larger corporates with complex IT needs. Since listing, investors in Accenture have been richly rewarded, with shareholder returns compounding at more than 19% p.a. for the last ten years. Interestingly, c. 40% of this return, or 8% p.a., has come in the form of a continuous, and consistent, re-rating of the counter over this time.

Figure 1: Accenture Plc PE ratio (12m blended forward)

Source: Bloomberg

A good thirty years on from the mass adoption of information technology globally, the IT industry is at the beginning stages of another mass movement; the protection of data and usage of cloud storage. These two key themes are shaping the needs of global corporations. Brick-and-mortar companies are focused on improving or establishing a digital presence, companies are moving important data from internal data centres to the cloud and enterprises are investing heavily in cyber-security defences as hackers become more sophisticated and dangerous. As transacting is moving away from the storage of physical documentation, the need to keep data protected is as in demand as ever and the value placed on protecting that data means that consulting firms like Accenture are well positioned to benefit from this demand.

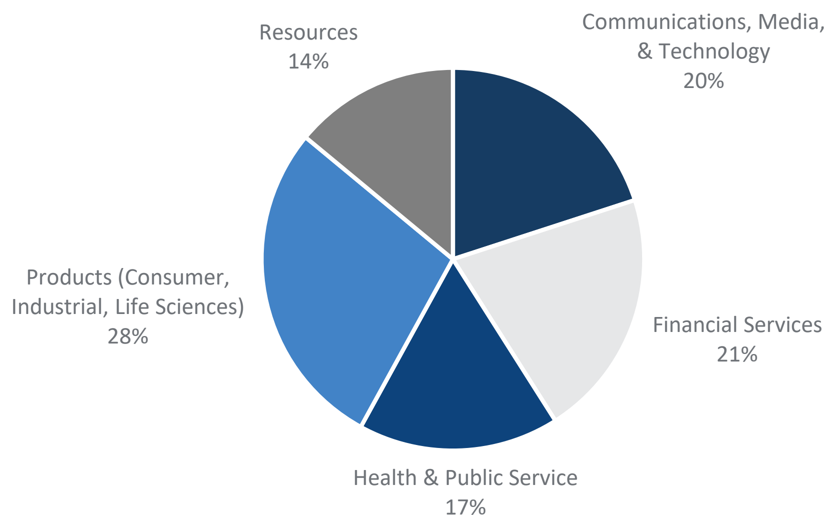
For IT consulting firms, like Accenture, forecasts by global IT association CompTIA (The Computing Technology Industry Association) put the growth in the overall IT service economy at 5% p.a. over the medium term.

In making the assessment of whether a business will make a good investment, our internal processes at Anchor look for key pillars of a business. We then make a call as to whether this would make a sound investment, essentially tying the business and investment case together. Our fundamental approach earmarks high and stable or rising return on capital employed, quality brands, pedigreed management and sustainable competitive advantages as some of the vital qualities that will ensure the ongoing success of a business.

While we regard ourselves as bottom-up investors, we typically overlay our bottom-up view with a macro view - considering secular trends impacting the industry and markets in which they operate. From the bottom-up, Accenture looks like the high-quality business we like to look for. Brand recognition in the corporate world remains very high with confirmation of this coming through via the servicing of more than three quarters of the Fortune 500 companies (and 95% of the top 100). It is also impressive that all of Accenture's top-100 clients have been clients for more than five years and 98 out of the top-100 have been clients for 10 years or more. With annual revenues of $40bn, 150 clients account for c. 30% of this, on retainer. That is an average of $267mn p.a. for each of the top-150 clients. The concentration around these clients would be a concern as the relationship with the key personnel at Accenture and the client would give rise to the risk of those key individuals leaving and taking the clients with them. However, we would imagine the IT needs to be so complex for those clients that the risk of leaving and disrupting the status quo becomes very low.

Accenture's revenue streams are well diversified across the types of services it offers, the industries it serves, and the locations in which it operates. The company's five service areas are Accenture Strategy, Accenture Consulting, Accenture Digital, Accenture Technology, and Accenture Operations.

Figure 2: Divisional revenue split



Source: Bloomberg

Emphasis on the NEW

Since 2016, Accenture has been placing increased focus on what the business has phrased the "new" strategy. This is, essentially, the rotation of the business to new higher growth areas of IT needs being digital, cloud and security services, which grew revenues at 30% in FY17 and now accounts for more than 50% of Group revenues. Over time, the IT consulting industry has become largely commoditised and Accenture has had to become a leader in innovation and scale as it was becoming increasingly difficult to differentiate the service.

This is where the movement to digital (largely marketing and app-based services), cloud (service providers to Microsoft, SAP etc.) and security was established. The decision to focus on these areas of IT consulting needs ties into our outlook on the increased demand for data protection and cloud storage. The ability of management to innovate and execute as well as Accenture is a quality on which we are continuously placing increased emphasis.

In a recent interview Accenture CEO Pierre Nanterme had this to say on his take of the last 35 years at Accenture; "Accenture has changed a lot during that time, probably undergoing a new wave that drove significant changes to the business every ten years. We evolved from management consulting to systems integration and technology. Ten years after that came a new wave - outsourcing. Now we're facing the next wave, which I'll call global security and the digital revolution. Indeed, each reinvention of Accenture was based on the new technology waves that occurred. This revolution is a technology disruption, with many more tech disruptions ahead and coming at an accelerating pace. First, there's the digital marketing revolution, then mobile apps, then analytics and the A.I. revolution, then there's the cloud revolution, and then the cybersecurity and the encryption revolution."

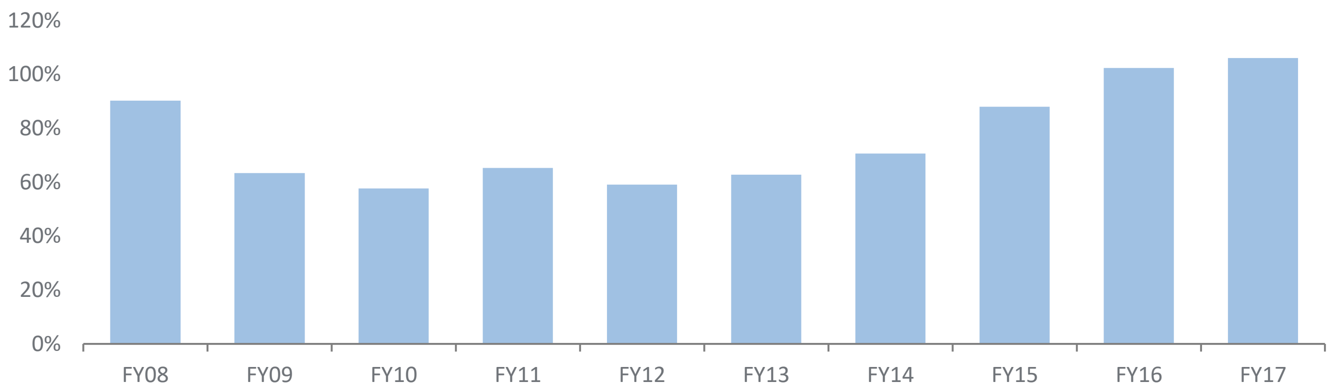
It is clear from the above statement that Accenture has identified the need to pivot in an industry that never seems to stop changing with the next evolution of Blockchain technology and AI looming on the horizon.

Simple operating model, low capital requirements and IP heavy

Accenture's operating model is that of a service provider; revenue and new business is contract based and the largest capital investment is human capital (expensed through the income statement). Costs are largely variable in nature with staff costs the biggest expense - total employees are in excess of 429,000. The real competition in the industry is that of skills and the cost effectiveness of those skills. Competitors with most staff in low-cost jurisdictions (such as India) have the upper hand when it comes to pricing on projects. As a result, Accenture has had to relocate 70% of the workforce to these areas to remain competitive. This is a trend we do not foresee reversing over the short-to medium-term.

The capital-light nature of the business has allowed Accenture to compound shareholder returns at alluring rates. By simply managing treasury effectively (share buybacks) and steadily growing earnings, the return on capital employed has continued on an upward trajectory.

Figure 3: Return on capital employed

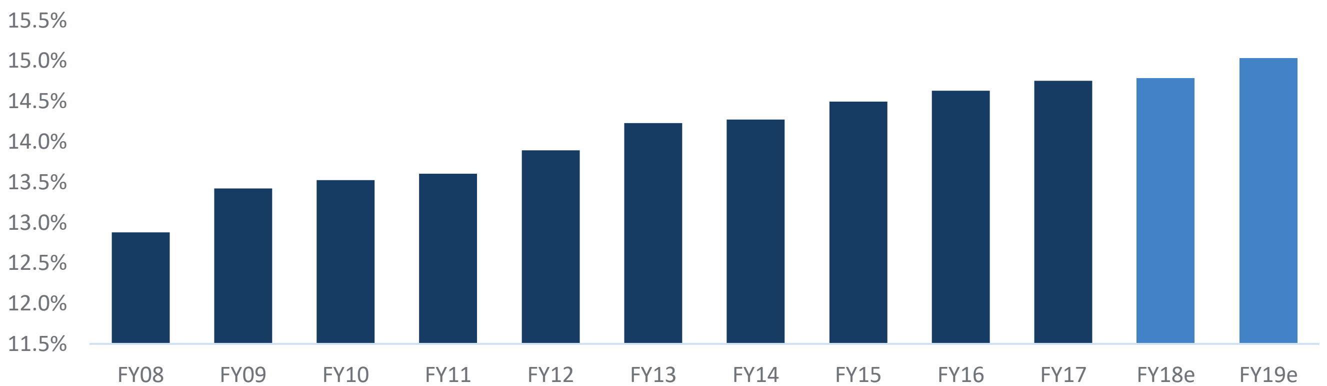


Source: Bloomberg

By our calculations, the business has consistently returned close to 100% of free cash flow to shareholders in the form of buybacks and dividends, making total shareholder returns look attractive.

At this stage, the focus needs to shift to sustainability of the continued upward return on capital trajectory. With costs largely variable in nature, the business needs to shift up a gear in revenue growth to achieve this and while the industry growth has a robust outlook, Accenture already has the leading position and would need to squeeze out the majority of the competition to experience a step change in the growth achieved. We would caution against betting on further rerating , especially so late in the economic cycle where asset prices are already looking fully valued at best.

Figure 4: Operating margin



Source: Bloomberg

The cyclicality of the industry is difficult to quantify at this point, largely because of the unknown nature of the current IT spending cycles. Traditionally, IT spend would be a key focus area for corporates to cut back on during times of contracting top lines (recessionary conditions) but with the increased effectiveness of data thieves (hackers), corporates would likely view data security as a necessity as opposed to a value-added service, the effective use of IT has become an existential issue. In addition, the shift to the cloud brings with it operating efficiencies that corporates could use to protect margins in tough trading conditions. There is, however, no doubt that conversations become far tougher with clients when they are struggling and the ability to increase contract pricing during a recession is likely to be very low. As the client set is so diverse we would expect to see the overall growth in revenue to be impacted by the broad-based global economic climate in the event of a cyclical downturn and with most costs variable in nature, the margin leverage would not be too severe.

As the world is currently moving towards the later stages of the current economic cycle, the recessionary risks would be key for us, although, other key risks we would pay special attention to would be:

- Talent retention and staff turnover.
- Competitor pricing trends, if margins start dropping for major competitors.
- Disruptive technologies reducing the need for major outsourcing arrangements.
- Single event risk. One wouldn't need to look beyond the firm that originally housed Anderson Consulting for an example of how fragile these firms are to large single events that can damage the integrity of the brand.

The above risks are risks for the sake of identifying them. A global recession will likely hit more than three quarters of the global investable universe (there will be no place to hide) and should not take the shine off the exceptional business that Accenture represents. The decision as to whether, at this stage, it would be prudent to have more than a few percentage points of a portfolio in Accenture is a difficult conundrum. The continuous repricing of the share leaves it vulnerable to any form of operational misstep or external shock. At the same time the share will likely retain a premium rating for as long as the company outperforms peers (a trend we expect to continue) and industry fundamentals remain supportive. Should current conditions persist, we expect earnings to compound at 10% for the next three years. At a share price of $168, the forward PE multiple of 23x leaves little room for further upside to the valuation and would lead us to conclude that, at best, the share will likely deliver 10% - in line with the expected earnings growth.

Earnings outlook

Accenture

DECEMBER Y/E	FY17A	FY18E	FY19E	FY120E
Diluted EPS	$ 5.97	$ 6.71	$ 7.26	7.88
% growth		12.32%	8.20%	8.54%
DPS	$ 2.42	$ 2.61	$ 2.82	$ 3.06
PE	28.1x	25.x	23.1x	21.3x
DY	1.44%	1.55%	1.68%	1.82%
Share price	168.00			
12-mnth fwd PE	23.1x			
12-mnth fwd DY	1.7%			

Source: Bloomberg

Valuation

		FY19E	FY20E	FY21E	TERMINAL VALUE	
Free cash flow ($mn)		$ 4,693	$ 5,162	$ 5,679	$ 113,571	5% free
Discount factor		0.93	0.86	0.79	0.74	cash
Present value		$ 4,345	$ 4,426	$ 4,508	83,478	Flow yield
Fair value ($mn)	$ 96,757					
Shares in issue	654.7					
Fair value per share	$ 148					
Share price	$ 168					
Premium/Discount to fair value	12%					

Source: Anchor

A method we would typically use at deriving a fair value for a service business like Accenture would be to capitalise the year-3 free cash flow at an appropriate free cash flow yield and discounting that value back to today. Using this methodology, the share appears 12% overvalued. Although, we concede that the model is very sensitive to the 5% fair free cash flow yield assumption.

Accenture ticks all the boxes we like to look for in a business, however, our job is to continuously look for the next Accenture - before the repricing takes place. The structural compounder we do not need to overpay for and when one has the luxury of investing anywhere around the world, these opportunities present themselves all the time.

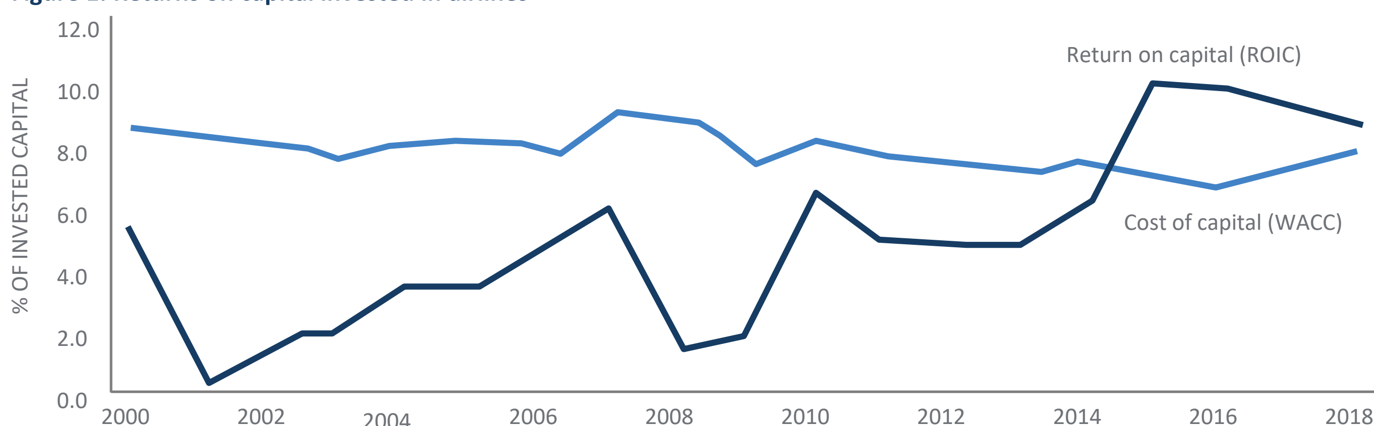
SOUTHWEST AIRLINES:
A LEADING LOW-COST CARRIER

David Gibb
Fund Management

Southwest is a famous name in the airline industry. It was the first of the low-cost airlines, and has an operating model that has been copied many times over across the globe – think Ryanair, Kulula etc. Southwest started in the early 1970s, flying out of Dallas, Texas and adopting a point-to-point system of flying, as opposed to the hub-and-spoke system used by the now legacy carriers, Delta, United and American. This combined with a focus on only using certain single-aisle Boeing aircraft, plus a jovial culture, allowed it to become the lowest-cost operator in the industry. According to *Fortune*, Southwest is now the most admired of all airlines and the 8th most-admired company in the world. It is also the largest domestic airline in the US.

However, this is a tough industry. Cumulative losses in the US airline industry alone were $35bn from deregulation in 1978/79 to 2014. Globally, airlines go bankrupt on a regular basis. The returns on capital for the global airline industry are low, seldom rising above the cost of capital.

Figure 1: Returns on capital invested in airlines



Source: IATA

According to *IATA*, Africa is the most financially precarious of all the geographies for airlines. Airlines have a huge fixed-cost base and, as Gary Kelly CEO of Southwest explains, 'there is tremendous operating leverage in an airline'. They are also stuck between an aircraft industry with two major producers – Boeing and Airbus – and an airport industry where there is typically very little competition. Most employees are members of unions. So, like the railway industry, the airline industry is typically only financially viable when there are a few large airlines – i.e. when competition is limited and when it behaves responsibly. After US Airways and American Airlines merged in 2013, the 'Big 6' became the 'Big 4' and things appeared to change. When oil prices dropped in late 2014 and airline load factors rose (underpinned by industry consolidation), US airline industry profitability never looked back. Profits are not spectacular, but they exceed the cost of capital and operating margins are higher than in all other major geographies in the world. For the first time since the deregulation of the US airline sector in 1978, industry prospects are more stable. Warren Buffett noticed the change and, in 2016, bought stakes in all four major US airlines.

Southwest has been the most consistently profitable of the 'Big-4' airlines, with the others all having sought bankruptcy protection at some point. Although operating margins at the low-cost carrier peaked in 2015 at 20.8% after a strong increase from a low of 3.6% in 2012, they remain solidly in double-digits (16.6% in 2017). The rising oil price means that margins will continue to decline in 2018. But the drop in the US corporate tax rate, will push earnings per share higher by some 19% in 2018. Capacity growth (i.e. available seat miles) will grow by 4% in 2018, in-line with the growth in 2017. With the US economy performing well, Southwest aircraft are full of passengers with load factors in recent years consistently over 80%. Ticket prices are declining modestly. The key point is that the industry is demonstrating 'capacity discipline' which is what you may expect in a more concentrated market. This bodes well for the future.

Figure 2: The evolution of Southwest's network

	1996	2006	2017
Daily departures[1]	>2,100	>3,200	>4,000
Market share[2]	11%	18%	24%
Number of cities[3]	49	63	100
Number of states[3]	24	32	40
Number of countries[3]	1	1	11
Fleet[4]	234	481	706
ROIC[5]	12%	11%	25.9%

Source: Southwest Airlines

1During peak travel seasons.
21996 market share based on enplaned passengers; 2006 and 2017 market share based on revenue passengers. 2017 market share data presented herein as measured by the Department of Transportation O&D Survey for the twelve months
ended September 30, 2017 based on domestic originating passengers boarded. O&D stands for Origin and Destination.
32006 includes 32 states and the District of Columbia; 2017 includes 40 states, the District of Columbia, and the Commonwealth of Puerto Rico.
4Fleet is as of December 31 for each year shown.
5ROIC is defined as annual pre-tax return on invested capital, excluding special items and is for the twelve months ended December 31 for each year shown.
6These results will be recast primarily due to the retrospective application transition option selected as part of the Company's adoption of Accounting Standards Update 2014-09, Revenue from Contracts with Customers. See the Company's Current Report on Form 8-K furnished to the Securities and Exchange Commission on March 20, 2018 for further information.

Although we like management, the cost structure, and the future prospects for Southwest, we are not suggesting that our clients buy the shares now. At a recent price of $62/ share, the upside potential is not enticing enough. Our discounted cash flow (DCF) value for the business is $72.50, or 17% higher than the share price. We would recommend a buy closer to $50/share - a level that was previously reached in May and June of this year.

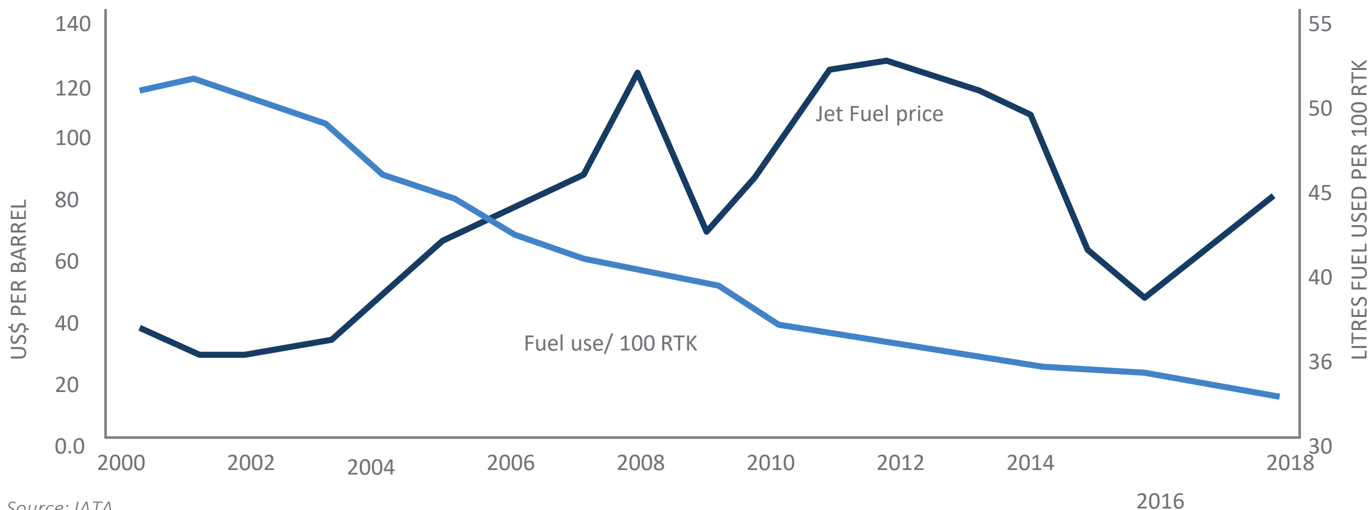
Figure 3: Earnings estimates and valuation

	2017	2020	% Ch	2020	% Ch	2020	% Ch
Diluted EPS	3.50	4.18	19%	5.07	21%	5.67	12%
DPS	0.475						
Divi Yield	0.8%						
PE	17.6	14.7		12.2		10.9	
Share price		61.65					
DCF		72.48	18%				

Source: Anchor

What might cause the share price to drop? With oil prices rising due to lower above-ground global oil stocks and concerns about underinvestment in new oil discoveries in recent years, this is one factor posing problems for airlines. In 2017, fuel costs represented 18.6% of Southwest's revenues. This number had risen to 20.8% in 1H18. Although Southwest does hedge against the oil price, with hedging 'really kicking in at $80 per barrel of oil', they will be materially impacted by the higher price if it is sustained. It will be interesting to see what happens to US airline ticket prices if oil prices continue to rise. Will prices drift upwards again? This would be noteworthy because when oil prices dropped in 2014 and 2015, ticket prices did not decline very much (unlike Europe, where the drop in oil prices triggered a fare war).

Figure 4: Fuel efficiency and the price of jet fuel



Source: IATA

Aside from oil, employee wage demands may escalate in a tight US employment market. We note that 83% of Southwest staff are unionised. Finally, a downturn in the airline business cycle would depress load factors, hurting operating profits.

We conclude that, while we like the change in the US airline industry dynamics, we would prefer investing in the leading low-cost carrier, Southwest Airlines, at a lower price. Such a share price decline may happen if oil prices continue to rise. We highlight that the good news is that Southwest now operates in a more rational industry.

Figure 5: Southwest share price performance, $

Source: Bloomberg, Anchor

KAP INDUSTRIAL HOLDINGS: QUALITY AT A DISCOUNT

Henry Biddlecombe
Investment Analyst

JSE Code:	KAP
Sector:	Industrials
Mkt Cap:	R20.75bn
FY:	June
Share price:	R7.23 (at time of publication)

At KAP's FY18 results presentation, management described a year to forget. The collapse of Steinhoff in December 2017 not only left the business without a corporate services function virtually overnight, but also naturally became a significant distraction for management as ill-founded concerns of potential contagion drew concern from shareholders, funders, suppliers and customers. Additionally, the primary equipment supplier for the group's major expansion of the Hosaf polyethylene terephthalate (PET) plant (c. 11% of group operating profit in FY17) filed for bankruptcy mid-project, leading to cost overruns and delays that resulted in a 81% decline in operating profits from that division over the last year (equating to a 9% drag on group operating profits).

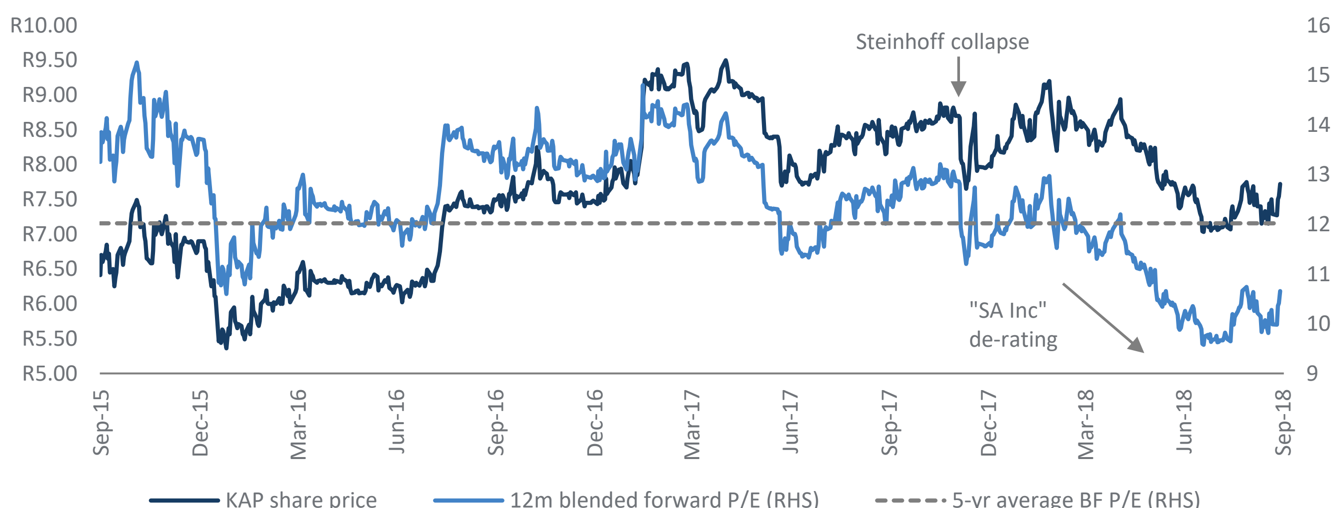
Despite what can absolutely be defined as extenuating circumstances, the group reported a commendable performance for FY18 – growing revenue by 16% YoY, operating profits by 14.7% YoY and HEPS by 9% YoY. This represents the seventh straight year of earnings growth from KAP after the injection of Steinhoff's industrial assets in 2012.

Looking forward, we expect this rate of growth to increase materially into FY19 as the various expansion projects in the Diversified Industrial and Diversified Chemical segments are now complete and should drive both volume growth and operating margin expansion.

Importantly, the group's balance sheet remains relatively flexible - with net debt: EBITDA at just 1.5x presenting management with significant optionality to effect a combination of acquisitive and organic expansion as, and when, opportunities arise.

Despite the improved FY19 outlook, the share hasn't been immune to weakening sentiment towards businesses geared to the SA economy. Additionally, the potential sale of Steinhoff's 26% stake in the business has also likely weighed on the counter (see Figure 1). We believe these factors have created an opportunity for investors, with the current valuation of KAP Industrial Holdings undervaluing the growth prospects of the business and undervaluing its ability to convert profits into cash.

Figure 1: KAP share price vs 12m blended forward P/E

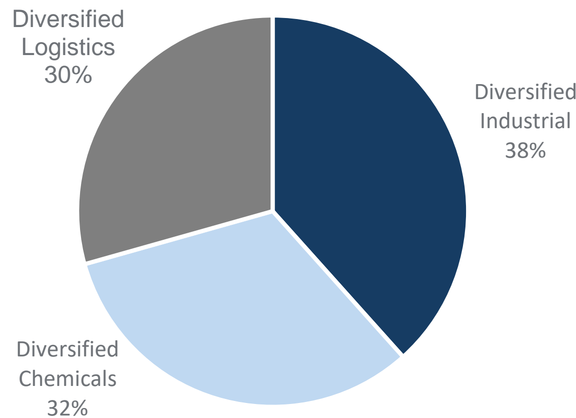


Source: Bloomberg

Diversified Chemical: Hosaf recovery will be meaningful

Following the integration of recently-acquired Safripol with Hosaf, the Diversified Chemical segment has now become the largest in the group – accounting for 38% of group operating profits (see Figure 2). Backing out the contribution from Hosaf and Woodchem for FY18, we estimate that Safripol grew operating profits at around 20% for the year – a positive indication that the integration has gone well.

Figure 2: FY18 operating profit contribution by segment



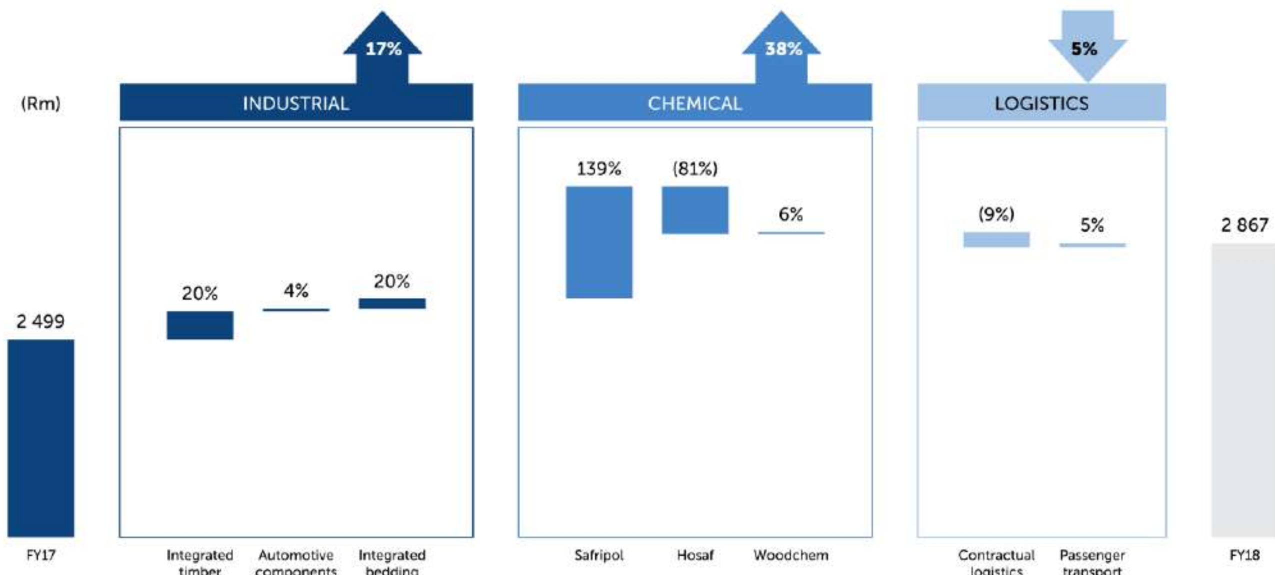
Source: KAP FY18 results

Although this segment demonstrated 38% in absolute operating profit growth for FY18, this was largely driven by the inclusion of Safripol for a full year (previously included for 6 months in FY17). The segment's profitability was meaningfully offset by delays and cost overruns of the capacity upgrade at Hosaf, where the business was forced to import finished PET resin (its primary output) for resale to maintain customer relationships.

Of course, this meant foregoing most of the margin on the product - essentially destroying the business' profits (Hosaf operating profits were down 81% YoY in FY18 - see Figure 3) and pulling the segment's overall operating margin down from 12.3% in FY17 to 11.5% for FY18. As Hosaf operations return to normal in FY19, we expect the Diversified Chemical segment's operating margin to recover meaningfully to 13.8% (see Figure 4).

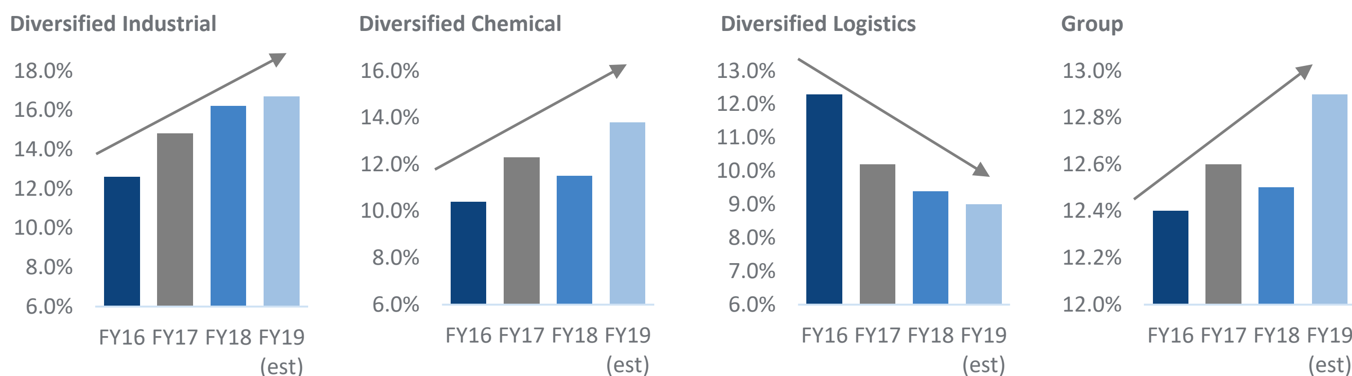
Even before accounting for the volume growth resulting from the Hosaf plant expansion, a simple recovery in margins will represent a positive swing in group operating profits of c. R220m (+8.8% on FY18) or HEPS of around ZAc6 (+10% on FY18) – a significant driver of group earnings growth for FY19.

Figure 3: FY18 operating profit growth per segment



Source: KAP FY18 results presentation

Figure 4: Progression of operation margin by segment

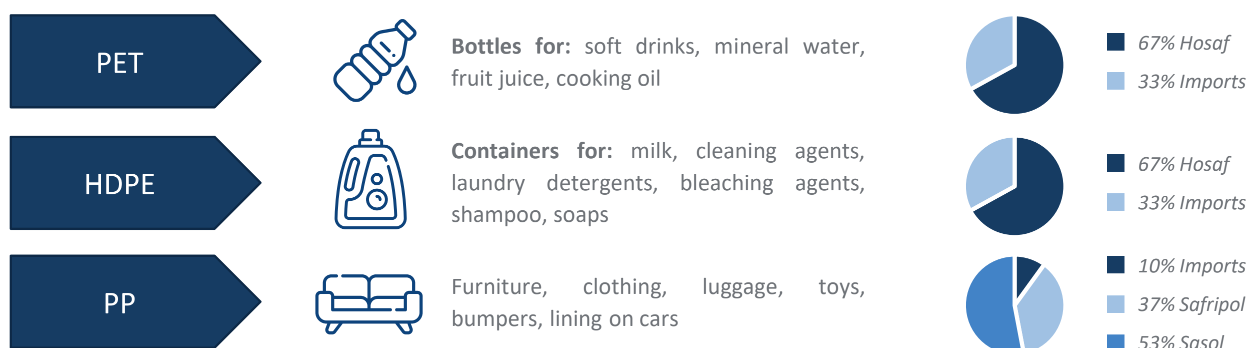


Source: Anchor

Going forward, the Diversified Chemical segment is well-placed to grow as the local market for the collective product set remains underserved. Imports currently service the market's supply deficit, and this remains a structural opportunity for Hosaf (see Figure 5). The now-complete expansion project has increased Hosaf's capacity by 85%, and we expect this to be fully utilised quickly (within 18 months). To put the expansion into context, we estimate full utilisation could contribute up to R235m on operating profit – or 9.5% at group level based on FY'18 numbers.

It is also important to note that the Diversified Chemical segment's revenues and input costs are US dollar-denominated. Given the average exchange rate realised over FY18 of R12.84/$1, the current weakness of the rand could well serve as a significant tailwind for this segment's operating profit growth should it sustain throughout FY19.

Figure 5: Import replacement a structural opportunity



Source: KAP Industrial Holdings investor presentation

Diversified Industrial: Driving operating margin expansion

The Diversified Industrial segment posted yet another year of operating margin expansion to 16.2% (FY17: 14.8%), led by the timber and integrated bedding businesses.

Recent investments into PG Bison's production capabilities and capacity have underpinned an active drive to shift this division's sales mix in favour of more profitable "value-add" products (i.e. high-gloss and textured decorative panel products). The resultant margin expansion has become a significant driver of profit growth, with 7% revenue growth driving operating profit growth of 20%.

The integrated bedding business – still run by the energetic founding family - also benefitted from the investment in a state-of-the-art integrated bedding plant in central Johannesburg. Higher levels of vertical integration, improved efficiencies and positive operating leverage have resulted in 20% YoY operating profit growth on the back of just 12% YoY revenue growth for FY18 – a trend which we expect to continue in FY19.

Going into FY19, we expect the annualisation of the benefits of investments in this division to continue to drive operating margin expansion in this segment – albeit at a slower pace (see Figure 4). The automotive components division, which experienced flat revenues in FY18, also stands to benefit from any pickup in new car sales – although this is contingent on an improvement of the prevailing macroeconomic backdrop in SA.

Diversified Logistics: operating environment remains challenging

In contrast with the positive operational momentum in the other two segments, the Diversified Logistics segment's operating margins have been impacted by competitive market conditions, a subdued operating environment and material cost push inflation.

Management are focusing on retaining the long-term contractual revenue base despite some resultant margin erosion, allowing the business to retain the critical mass that will be necessary to fully leverage a potential economic recovery. The recent BEE deal concluded within the contractual logistics divisions will also assist in customer retention efforts.

We do not expect this division to materially contribute to earnings growth over the medium term.

Balance sheet optionality

Management have guided to a year of consolidation in FY19, given the numerous expansionary projects undertaken in FY18 and the recent integration of Safripol and Hosaf. While we expect these initiatives to drive meaningful growth in FY19, there remains a material level of optionality in the balance sheet.

Assuming a leverage ceiling of 2.5x net debit : EBITDA (below management's previously communicated maximum) and an average deal multiple of 8x, we have illustrated the potential impact on FY18 earnings were this capacity to be deployed (see Figure 6). The incremental impact on earnings is significant.

Despite the recent cost overruns in the Hosaf expansion project, we still back management to allocate capital effectively. The numerous expansion projects across the group have improved group returns over time, and Safripol is evidence of successful M&A execution.

Figure 6: Group balance sheet capacity over time

Rmn	FY'18	FY'19E
Net debt	R 5,727	R 5,122
EBITDA	R 3,912	R 4,637
Net Debt:EBITDA	**1.5**	**1.1**
Additional debt capacity @ 2.5 debt:EBITDA	R 4,053	R 6,471
Average deal P/E	8.0	8.0
Incremental NPAT	R 507	R 809
Interest charge (post-tax)	-R 268	-R 429
Incremental NPAT	**R 238**	**R 380**
% accretion on FY'18 earnings	**14.8%**	**19.8%**

Source: Anchor

Temporary setbacks yielding an opportunity

Over time, KAP has enjoyed a rerating that has reflected its consistently improving return on equity profile (see Figure 7). We believe the recent dislocation between the share's rating and improving RoE profile is a function of several shorter-term influencing factors, which include:

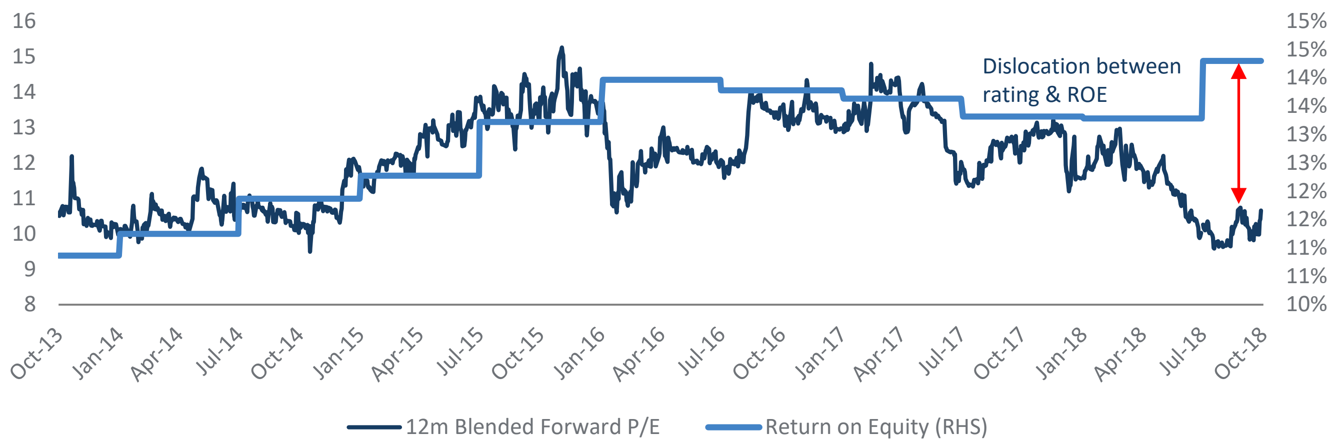
- Generally negative sentiment towards companies geared to the South African economy;
- The overhang of a potential sale of Steinhoff's 26% stake in the company; and
- Temporary pressure on group operating margins due to the loss of Hosaf profitability in FY18

Naturally, this presents investors with an opportunity. We believe the KAP structural margin expansion story remains intact, with the group's return on equity profile set to resume its rising trend from FY19. Earnings growth is also expected to accelerate meaningfully into FY19 as the Diversified Chemical segment's profitability normalises and the benefits of the group's various expansionary investments annualise.

On a discounted cash flow (DCF) basis, we estimate that the share currently trades at a discount of 22% to its fair value – which we estimate to be R9.47/share. We expect the primary catalyst for a rerating to be the group's 1H19 results, which should exhibit a return to operating margin expansion. Certainty around Steinhoff's potential disposal of its 26% stake in the group, and improved sentiment towards the South African economy would also likely drive a positive rerating over the coming months.

We find the prospective total return of 25.6% over the next 12 months to be attractive on a relative and absolute basis, and hence we find this to be an attractive investment opportunity.

Figure 7: KAP's 12m blended forward P/E vs ROE



Source: Bloomberg; Anchor

Figure 8: Forecasted metrics

FY JUNE		FY'17		FY18		FY'19E		FY'20E
Diluted HEPS	R	0.55	R	0.60	R	0.70		0.80
% growth		14.6%		8.6%		16.7%		15.3%
PE		13.9x		12.8x		11.x		9.5x
DPS	R	0.21	R	0.22	R	0.26	R	0.30
DY		2.7%		2.9%		3.4%		3.9%
RoE		14.2%		13.4%		14.3%		15.1%
Share price	R	7.64						
Market cap (R'm)	R	20,535						
12m fwd PE		10.6x						
12m target price	R	9.47				12m total return		27.3%
Implied 12m Fwd P/E		13.1						

Source: Anchor

THREE MONEY MEMORIES

Tamzin Nel
Portfolio Management

About a year ago, I wrote in the Strategy report about the enthusiasm and energy which encapsulates our passion at Anchor and how this enthusiasm has led to a constant evolving of the company. I spoke about the people that constitute our business and the responsibility that we have to ensure that our clients' experience of Anchor's overall strategy and asset allocation is pertinent and meets their specific investment needs, objectives and constraints. I also mentioned that we want you (our clients) to understand the context of investing in the world in which you live and how it impacts your finances. In addition, whilst it matters to us that your personal asset allocation falls in line with our general strategy, it is more important to us that this also suits your individual return and risk profile.

But, how do we determine this personal profile?

Financial behaviour tends to be more emotional than rational and your financial behaviour, as with the rest of your actions, is a deep-rooted expression of your internal psychology.

So, let us begin as you would any therapy session, with questions about your childhood.

What is your earliest memory of money?

This might sound like a strange question to ask, but as internationally acclaimed personal financial expert, Suze Orman has said; "It's amazing how much the mind can play a role in creating or destroying financial freedom. These money memories have such a hold on our lives—they directly impact how we deal with our money or we don't deal with our money." How we consciously and unconsciously behave is significantly impacted by our childhood or our memories thereof.

I have spent a considerable amount of time (and money!) on understanding my general and financial psychology and the above question is one which I find particularly interesting and thought-provoking – maybe because I spend all day, every day, surrounded by money and its impact on the world around us.

I am fortunate that my mom played a constructive and positive role in my financial upbringing. Even though (or possibly because of the fact that) we did not always have access to an excess amount of money, we spent a lot of time talking about it. A topic which is normally taboo but one which I believe should be a top priority in conversations between people.

My first money memory: The coins in the chest of drawers

In my bedroom is a chest of drawers passed down from my great-grandmother to my grandmother to my mother and now on to me and which forms an integral part of my first money memory. Every Sunday afternoon my sister and I would kneel in front of this chest of drawers holding a glass jar each (which probably previously contained tuisgemaakte appelkooskonfyt) and my mom would give us – and I forget the exact value – but say R10 worth of ZAc10 coins which we would place in our respective jars. During the week if we were naughty or cheeky (mostly me) she would remove a coin and if we were good or obedient (mostly my sister) she would add a coin. Naturally, my sister would always have more spending money than me by the end of any particular week.

The lesson learnt: consistently good behaviour pays off.

Throughout school, university and now in my working career, I have never been the most intelligent or naturally adept at anything I do, but I have always been diligent and consistent. Like it did for my sister back when we were small children, good (financial) behaviour has paid off for me and coins keep getting added to my money jar.

My second money memory: breaking bread in the parking lot of a supermarket outside Disney World

Just before my tenth birthday, our family went to Disney World, Orlando. Obviously, I have so many memories of this trip, but one of my favourites is of the five of us sitting in the parking lot of a supermarket, breaking bread. For lunch every day we would enjoy fresh chip rolls washed down with a cold Game sports drink. My mom had packed Game sachets in our suitcases and would prepare and freeze bottles of juice for us every evening for the next day. We did not eat the overpriced food and drink in the parks, but we still got to experience the magic of Disney (and the occasional ice-cream or sweet treat) thanks to months of planning.

The lesson learnt: if it is important to you (for example, travel), budget and sacrifice that which is not essential for the overall experience.

What people choose to spend their money on is exactly that – their choice. The adventure and experience inherent in travel was an important part of my upbringing and remains so in adulthood. There is this saying that you should "create a life that you do not need a vacation from" and whilst I understand the intent behind these words, I have created a life which enables me to always have the next vacation booked and planned. Last year, I spent an unforgettable three weeks in Scandinavia with my family which was only made possible thanks to my work ethic (lesson one), extensive planning, detailed budgeting and, true to tradition, packing snacks in suitcases and surviving on squashed rolls wrapped in serviettes.

My third money memory: you can pack up a house in 48 hours but the need for a home lasts a lifetime

At the beginning of my second year at University, my mother, sister and I found ourselves in the position of having to pack up the house we had been living in for five years and finding somewhere else to live at very short notice. We spent the next 48 hours packing up all our material belongings and unpacking our immaterial attachments to these. That very next Monday my mother started at her current job, just over a year later I started working and my highly intelligent and accomplished sister got a scholarship funding her studies and living expenses and the three of us moved into our own flat. The years spent there were some of our happiest and most carefree.

The lesson learnt: working, which affords the stability and security of my own home, is very important to me.

Someone once remarked to me that I would work for less because money is not important to me and I have spent quite a bit of time reflecting on this comment. Whilst it is true that money in terms of how that particular person views money as a status symbol is not important to me, money, in terms of what it means for me and allows me to do is vitally important.

I started working a year or two before most of my peers and bought my first home at the age of twenty-two. Whilst I tried to keep up with the weeknight social life my peers were still enjoying during their Honours year, I had to be presentable and professional at my job by 8 AM the next morning. Then, when my peers all started working and enjoying dinner and drinks out thanks to newly increased disposable incomes, I had a bond payment which left me with little to no disposable income. I am not dismissing the difficulty of completing Honours and I am definitely not dismissing the fact that I love my social life and enjoy dinners with friends. What I am trying to highlight is that because I know that freedom, for me, means having the stability and security of my own home first, this was a choice that I would make again, no matter how tough.

The importance of money in our lives is true for all people, the reason for it being so is different. I have highlighted only three of my own money memories which have helped me manage my relationship with money.

However, it is also important to note that, as with any relationship, there is a light and dark side to mine. Relating this to the above-mentioned memories; when I am unable to be both diligent and consistent I allow anxiety to overwhelm me. I have a constant requirement, of myself, to always deliver and when this is not rationally possible, I become irrational. I used to restrict myself completely by my budgets and if any unexpected expenses had to be incurred, I would panic. I could not just enjoy an experience for what it was or live in the moment but instead focused on the monetary demise (even thought it was never that bad). The last money memory and its lesson – my sensitivity to always be financially independent and be secure in this independence – is probably the one that has impacted me most. In my quest for financial stability, I have sacrificed and continue to sacrifice other things that are also important to me and this is an ongoing lesson in understanding and accepting myself.

Financial integrity encompasses understanding why you manage money in the way that you do and feeling competent to either continue in that manner, or to make the necessary changes.

For quality advice in the search for a solid state of financial health, get in touch with your Anchor representative and take a trip down the money memory lane. We would encourage you to spend some time exploring your earliest money memory and then linking this memory to your current behaviour.

TAX EFFICIENCY IN INVESTING

Sandy van der Zanden
Wealth Management

Does tax really matter when making investment decisions?

Tax rates have been rising for several years now. Personal tax rates have gone up, and even structures such as trusts and companies are now heavily taxed in their own right.

EFFECTIVE TAX RATE	
Company Dividends	42.20%
Trusts	45.00%
Individuals (maximum)	45.00%

Source: PKF Publishers (Pty) Ltd 2018/2019 tax guide

Companies, trusts and individuals are paying almost half of their declared income in tax to the SA Revenue Service (SARS). Currently, an individual at the maximum income bracket is paying ZAc45 in tax for every rand earned. Now, more than ever, tax efficiency makes a material difference to your overall investment return. In fact, any tax saving is equivalent to an increased investment return. So, just how much difference can tax efficiency really make?

Let's run two simple R1mn cash portfolios side-by-side. One portfolio is invested in an individual's hands, in a simple interest-bearing bank account or money market fund. The other portfolio is also invested in the money market but with one important difference - the second portfolio is housed within a retirement annuity (RA). Assume a 30% average tax rate for the individual, with the interest exemption already fully utilised. The growth inside the RA is tax free. Let's assume a return of 6% p.a. on the investment. So what's the difference?

AFTER TAX RETURNS			
INVESTMENT TERM	DIRECT INVESTMENT	RETIREMENT ANNUITY	ENHANCED RETURN
1	R 1,042,818	R 1,061,000	R 18,182
2	R 1,087,469	R 1,127,159	R 39,690
3	R 1,134,032	R 1,196,680	R 62,648
4	R 1,182,589	R 1,270,489	R 87,900
5	R 1,233,225	R 1,348,850	R 115,625

In the individual's hands the 6% p.a. return is reduced by tax to become only a 4.2% after-tax return. The RA earns the full 6% and after one year the tax saving equates to an enhanced return of R18,182 inside the RA. After two years, the saving is R39,690. If you track the two portfolios over a period of 5 years, the RA outperforms the direct investment by R115,625. That amount is nothing to scoff at as it equates to 9.4% more in your pocket at the end of 5 years.

Aren't there restrictions on my money?

One of the main concerns around structuring investments is the restrictions on your capital - exit penalties, access to capital, increased costs and inadequate reporting are often noted (quite rightly) as investor concerns.

RAs, in particular, have been the focus of many of these queries. Restrictions on access to capital before the age of 55, and limits on underlying investment flexibility, should be clearly understood when housing investments inside an RA.

Tell me about the fees?

As the old adage goes there is no such thing as a free lunch. Structures do have associated fees and the effects of these fees must be assessed against any potential tax savings. Structures such as endowments and RAs have been the subjects of intense scrutiny from modern investors. New-generation products including modern endowments have done a lot to address concerns around fees with exit penalties removed, capital liquidity created through the issue of multiple policies (not applicable to RAs), and drastically reduced fees. These structures now merit a place in an overall investment portfolio.

What about estate duty?

South African tax payers with assets above the R3.5mn exemption are subject to estate duty (death taxes) at a flat rate of 20% currently. It is important to realise that your beneficiaries will only receive their inheritance after your estate has settled its bill with SARS. Without proper planning your estate could be handing the tax man up to one-fifth of all your assets. As daunting as this may seem there are tools available for estate-planning purposes.

A simple, and zero-cost, method of reducing estate duty is to leave assets to your surviving spouse. Any assets left to your spouse are currently exempt from estate duty and this preserves the R3.5mn tax exemption which can be used later in your spouse's estate. This means that, upon death, your spouse will benefit from a full R7mn estate duty exemption (the R3.5mn exemption x 2).

Do you have any assets held offshore? If so, beware of offshore death taxes such as situs tax. This is a tax levied for assets held offshore such as property and equities. The thresholds before this tax applies differs from country to country. The UK, for example, allows the first GBP325,000 free of inheritance tax. In the US the first $60,000 is exempt. The balance in both cases is then taxed at a flat 40% rate - double SA's estate duty.

Again, there are tools available to address this issue. Investing within an offshore insurance wrapper, for example, has the advantages of not attracting situs tax, even while holding the same underlying taxable assets - that is a 40% boost to your heirs on death! Beneficiary nominations on these structures will also assist further by avoiding executor fees (another 4% saving).

So which structure is the right one?

For simple investing, often a single structure may be appropriate. More complex portfolios may require several structures including trusts, companies, endowments, RAs etc.

An important note around any investment structuring is to update your will as required. There may even be a need for two wills – one for your local assets and one to deal with any assets held offshore. Specialist advice should always be sought, as required. It is essential for any structures to correctly reference any affected assets and to take cognisance of applicable legislation and taxes in the relevant jurisdictions.

To whom should I be talking?

Ideally, your accountant, legal counsel (where applicable) and wealth manager should be aware of any structural changes to your portfolio.

In summary

It is every taxpayer's right to structure their affairs and investments in the most tax-effective manner possible. Tax is never the sole consideration but instead forms part of the overall investment plan.

Smart tax planning is just good investment sense, and will affect your returns over the long term.

Disclaimer: The contents of this article is for information purposes only and the accuracy, completeness, timeliness, or correct sequencing of any of the information contained herein cannot be guaranteed and should thus not be construed as investment advice. Readers should thus only act thereon after having consulted their financial adviser.

05 PERFORMANCE SUMMARY

		FUND PERFORMANCE						BENCHMARK PERFORMANCE					Performance vs Benchmark
	Start date	Annualised p.a.	Since inception	12 Month	6 Month	3 Month	Sep 2018	Since inception	12 Month	6 Month	3 Month	Sep 2018	
UNIT TRUSTS													
Anchor BCI Equity	Apr-13	12.8%	94.1%	-0.68%	1.7%	-0.4%	-3.2%	59.8%	0.4%	-2.5%	-1.7%	-4.2%	34.2%
Anchor BCI SA Equity	Jan-15	2.5%	9.5%	-0.7%	0.7%	-0.9%	-3.5%	16.6%	0.4%	-2.5%	-1.7%	-4.2%	-7.1%
Anchor BCI Flexible Income	Jun-15	7.5%	27.2%	5.5%	3.2%	2.1%	0.7%	30.3%	8.2%	4.0%	2.0%	0.6%	-3.1%
Anchor BCI Managed	Jan-15	4.3%	16.7%	-0.5%	2.4%	0.3%	-2.5%	44.4%	9.9%	4.9%	2.3%	0.3%	-27.7%
Anchor BCI Worldwide Flexible	May-13	12.4%	87.7%	8.45%	17.1%	3.9%	-4.5%	61.0%	8.9%	4.4%	2.1%	0.2%	26.7%
Anchor BCI Property Fund	Nov-15	-1.2%	-3.4%	-7.4%	-2.1%	0.2%	-1.6%	-6.1%	-15.7%	-3.2%	-1.0%	-2.6%	2.7%
Anchor BCI Global Stable Feeder	Nov-15	0.7%	2.0%	5.56%	20.2%	4.0%	-4.1%	15.6%	11.7%	25.9%	7.3%	0.0%	-13.6%
Anchor BCI Global Equity Feeder	Nov-15	10.2%	32.7%	16.6%	26.1%	5.7%	-4.2%	38.6%	14.9%	25.6%	7.4%	-3.2%	-5.9%
Anchor BCI Bond Fund	Feb-16	9.9%	28.3%	6.4%	-2.9%	0.3%	0.3%	27.5%	7.1%	-3.0%	0.8%	0.3%	0.8%
Anchor BCI Diversified Stable Fund	Feb-16	7.0%	19.8%	5.8%	4.5%	2.2%	-0.8%	16.8%	4.7%	4.5%	1.6%	-1.3%	3.1%
Anchor BCI Diversified Moderate Fund	Feb-16	6.0%	16.8%	4.8%	4.6%	2.2%	-1.6%	15.3%	3.9%	5.1%	1.5%	-2.1%	1.5%
Anchor BCI Diversified Growth Fund	Feb-16	5.1%	14.1%	4.1%	4.2%	1.5%	-2.4%	15.1%	3.1%	4.6%	1.1%	-2.7%	-1.0%
Anchor BCI Africa Flexible Income	Mar-16	5.7%	15.2%	6.0%	10.2%	4.7%	0.4%	26.2%	9.2%	4.5%	2.2%	0.7%	-11.0%
EQUITY NOTES & SEGREGATED MANDATES													
Anchor Equity	Jul-13	9.6%	61.9%	-1.9%	1.6%	1.4%	-2.3%	58.7%	0.4%	-2.5%	-1.7%	-4.2%	3.2%
Equity	Apr-12	12.5%	68.3%	-15.2%	-5.5%	-2.0%	-2.2%	65.0%	0.1%	8.0%	5.0%	-0.1%	3.3%
Growing Yield	Jun-12	11.0%	91.7%	-6.9%	1.4%	2.2%	-0.5%	85.9%	9.9%	4.9%	2.3%	0.3%	5.8%
HEDGE FUNDS													
Long Short Equity	Mar-13	7.3%	47.5%	-3.5%	-2.0%	-2.3%	-3.0%	53.0%	8.8%	4.3%	2.1%	0.6%	-5.5%
Property Long Short	Jan-14	9.6%	54.8%	-4.6%	-1.2%	-0.2%	-1.7%	50.5%	9.4%	4.6%	2.3%	0.8%	4.3%
Anchor Accelerator	Feb-16	6.1%	16.5%	9.4%	5.8%	6.3%	2.1%	15.1%	0.4%	-2.5%	-1.7%	-4.2%	1.4%
OFFSHORE													
High Street Equity - Dollars	Jun-12	12.8%	112.4%	8.9%	3.5%	4.9%	0.3%	107.0%	11.8%	7.1%	5.1%	0.6%	5.4%
High Street Equity - Rands	Jun-12	23.1%	266.1%	14.3%	23.7%	8.2%	-3.1%	258.2%	17.0%	28.4%	8.3%	-3.0%	7.9%
Offshore Balanced - Dollars	Jun-12	10.8%	89.4%	7.0%	3.2%	3.5%	0.1%	55.2%	6.1%	2.5%	2.6%	0.0%	34.2%
Offshore Balanced - Rands	Jun-12	20.9%	227.2%	12.3%	23.4%	6.8%	-3.3%	168.4%	11.0%	22.7%	5.6%	-3.7%	58.8%
Global Dividend - Dollars	Jan-14	9.3%	51.2%	7.0%	5.4%	5.0%	0.5%	53.9%	11.8%	7.1%	5.1%	0.6%	-2.7%
Global Dividend - Rands	Jan-14	15.1%	92.4%	12.4%	26.0%	8.3%	-2.9%	96.0%	17.0%	28.4%	8.3%	-3.0%	-3.6%
Anchor Sanlam Global Stable Fund - Dollars	May-15	0.1%	0.3%	1.6%	1.2%	0.9%	-0.2%	9.4%	2.8%	1.4%	0.7%	0.2%	-9.1%
Anchor Sanlam Global Stable Fund - Rands	May-15	4.8%	17.0%	6.3%	20.9%	4.0%	-3.8%	27.5%	7.2%	21.1%	3.8%	-3.5%	-10.5%
Anchor Sanlam Global Equity - Dollars	May-15	9.7%	36.4%	12.7%	7.2%	2.7%	-0.5%	28.1%	9.8%	4.9%	4.3%	0.4%	8.3%
Anchor Sanlam Global Equity - Rands	May-15	14.9%	59.0%	17.9%	28.1%	5.8%	-4.1%	49.3%	14.9%	25.4%	7.4%	-3.2%	9.7%

Source: Morningstar and Bloomberg
Returns are quoted to 30 September 2018

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