Strategy and Asset Allocation Report
1st Quarter 2019

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Introduction

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Last year gave investors little to cheer about and has market commentators reaching for the history books to see when last the market behaved this badly. Charts, historical comparisons and discussions around why markets will bounce back don't adequately convey the fact that we all live in a real world, and experience real human emotions.

Investors in the South African equity markets on average saw their wealth eroded by 10% last year, with offshore investors faring little better. That these losses have come after two years without gains from the markets makes the human experience even more real. These are retirement plans that are being delayed, holidays that are being cancelled and belts that are being tightened – the human consequences of disappointing investment returns for the last three years. Investors are hurting.

If we look at US equity markets, where the available history is longer, we find that between 1928 and 2013 there were 20 periods of a 20%-or-more decline. The market, however, increased by nearly a hundredfold during this period, or 140-fold with dividends and inflation factored in.

Think about that. People saw at least one-fifth of their wealth melt away 20 times, or once every 4.5 years. But, during the overall period, a patient investor made 140 times their money in real terms.

To paraphrase *Patient Investors Will Always Win* by Morgan Housel, patient investors will view volatility like the flu. It's not fun. It does hurt. But, you're probably going to get it once a year. When you do, it's not the end of the world. Take a nap, drink some water. Life will go on, and you'll be healthy before long. Remember, the patient investor made 140 times their money in the period mentioned above by accepting that they will be getting the flu from time to time.

Investors need to think about their investment portfolio's asset allocation. If the pain from an unfortunate sequence of poor equity returns is that great, then bringing more asset class balance to your portfolio might be worth considering.

Investing is not a perfect science, but we are anticipating a year ahead that is significantly better than the one behind us.

The purpose of this document is to give our clients an insight into Anchor's thoughts on different asset classes and our near-term market outlook. Readers will see that we believe the fundamentals in South Africa have improved over the last year and, as a result, we think that current equity prices are attractive entry points to a number of stocks that should grow well in time to come.

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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 12m Fwd (ZAR)
	Negative	Neutral	Positive	
LOCAL				
Equity			●	16%
Bonds		●		10%
Property		●		12%
Cash		●		7%
GLOBAL				
Equity			●	9%
Government Bonds	●			-5%
Corporate Credit	●			-5%
Property		●		4%
Cash		●		-4%

Strategy and Asset Allocation

GLOBAL BACKDROP

Global economic growth, in aggregate, has been robust for the past two years. Unfortunately, it is becoming apparent that this will not be sustained going forward. We had been expecting growth to normalise to lower levels, but regrettably actions by various politicians have meant that growth rates will slow down faster, and to a greater extent, than we had previously anticipated. At the forefront of this slower growth are three key events:

- The US government has effectively entered a shutdown due to the political battle between President Donald Trump and the majority House Democrats. This means that a number of US government offices and services are now closed until the situation is reversed. In effect, this is the opposite of the fiscal stimulus that we spoke about in our previous Strategy report and acts as a handbrake on US growth rates in the near term.

- The trade dispute between the US and China is also taking longer to resolve than we had originally hoped. As a result, both the US and China's economies are being held back by a combination of uncertainty and slower global trade.

- The world has been waiting for Chinese stimulus in response to the damage sustained to the country's economy on the back of the trade dispute. Recently, ratings agency Fitch stated that further debt-fueled stimulus could see China's credit ratings getting cut. This is another possible sign that the scope for such stimulus is diminishing.

Whilst we are talking about a slowing global economy, we do not anticipate a recession and instead we think that the US will see its growth rates normalise to just below 2.0% p.a. This should be enough to sustain markets and is actually reasonably bullish for emerging markets (EMs).

We had been expecting growth to normalise to lower levels, but regrettably actions by various politicians have meant that growth rates will slow down faster

The South African (SA) economy disappointed us by dipping into a recession last year. However, we continue to see the green shoots of a recovery taking hold, despite a number of risks remaining – the 2019 general election and Eskom are at the forefront of investors' minds. We expect that the local economy will continue on the current recovery path with a continued gradual improvement. Nevertheless, the recovery remains fragile and we are hopeful that a sensible election outcome will allow for the bold steps necessary to improve our economy.

SOUTH AFRICAN EQUITIES

The SA equity market owes investors some returns and if the stars align, 2019 could be the year for payback. Valuations are at attractive levels and there are three main determinants of our fortunes: if Trump acts rationally, Chinese stimulus materialises and the "Ramaphosa-recovery" continues, the market could deliver meaningful double-digit returns. The decisions politicians make can alter the potential outcome materially so, for the purpose of our mathematical tables, we have worked on a 16% return for 2019. This comprises of 12% earnings growth, a c4% dividend yield and a slight rerating of the market multiples from 11.9x towards 12.0x, which is still below historical averages. There is a large dispersion of possible outcomes and, if the various scenarios (both locally and internationally) all turn out positively, there is significant upside optionality and the market could well deliver in excess of 25% returns.

Figure 1: FTSE JSE Capped Swix All Share Index performance, 2016 to date

Source: Bloomberg, Anchor

SOUTH AFRICAN EQUITIES

> CONTINUED

The JSE Capped Swix Index declined by 10.9% in 2018, which is particularly painful because over a four-year period it has produced a paltry annualised total return of 3.8%. The index currently trades at a forward multiple of 11.9x - well below its 10-year mean of 12.9x. We expect earnings growth in excess of 12% on the JSE this year, which might seem high given the tough economic conditions, but this is partly due to the make-up of the index, which we will explain later.

Valuations are cheap, aggregate earnings growth is solid and global markets have sold off fairly dramatically. These are all favourable factors for a stock market recovery.

In order to understand the JSE one needs to understand the constituents and their relative weightings. We think Figure 2 below is a good way to view the market.

Figure 2: JSE Capped Swix Index weightings by sector and share

Source: Bloomberg, Anchor

	Contribution	Expected Sector Earnings Growth
Banks	15%	7%
Naspers	10%	35%
Resources ex oil	12%	10%
Oil	5%	30%
Property	7%	4%
Telecomms	6%	12%
Other offshore	9%	12%
Other local companies	36%	6%
Weighted earnings growth		**12%**

The weighting of Naspers is higher in the All Share Index (roughly double the 10% in Figure 2), but the market norm is to use the Capped Swix Index, which limits any one share to a maximum weight of 10%. What one can see from Figure 2 is that there are numerous drivers of market performance and local economic performance only accounts for about half of that.

High projected growth numbers from Naspers and Sasol are the biggest drivers and these are relatively unrelated to local conditions, as are resource company earnings, which will be assisted by a weaker average rand vs US dollar exchange rate.

The earnings growth broken down by sector arrives at a surprisingly high number given the poor local economic conditions. High projected growth numbers from Naspers and Sasol are the biggest drivers and these are relatively unrelated to local conditions, as are resource company earnings, which will be assisted by a weaker average rand vs US dollar exchange rate in 2019, compared to 2018. This impact is also felt in the offshore company earnings translated into rand. The 34% "rump" of local company earnings (retailers, industrials etc.) are projected to grow at a far more subdued 6% p.a., along with banks who will battle to grow by more than nominal GDP in the current environment. Property companies have the lowest projected growth rate as negative lease reversions (on renewal) subtract from the base of contractual lease escalations.

The performance of the local market will primarily be influenced by the following (in order of importance):

The global growth outlook and the performance of global equity markets:

After a sharp drop in 2018, we believe the market is factoring in an overly negative expectation of 2019 global economic growth. We think global growth of over 3.5% and US earnings growth of around 6% is feasible. This should see a positive return from global markets. In a positive environment, EMs could well outperform developed markets (DMs).

The SA general election and its political outcome:

Conditions remain tough in SA and the path to recovery is a delicate one. SA desperately needs the "Ramaphosa-recovery" plan to be sustained to realise the country's economic potential. This is our base case and GDP growth should accelerate in 2019, albeit off a low base. It's all about confidence levels and if these improve the prospects for growth are good. To the contrary, if SA reverses course, the outcome would be calamitous and share selection would shift dramatically away from domestic counters. Political rhetoric is likely to dominate the headlines for the next few months, leading up to the election. Our base-case expectation is for the ANC to win the election with a sufficient margin to empower Ramaphosa to continue on his reform path.

US–Chinese trade negotiations and Chinese economic stimulus:

Trade negotiations are underway and a reasonable outcome, which does not overly restrict global trade or put pressure on Chinese growth, is an important factor for the year. Following this, the extent of Chinese stimulus will be key as the resource sector relies heavily on sustained Chinese demand. Our base case is a positive outcome on both counts.

The rand/US dollar exchange rate:

This is impossible to forecast with high levels of confidence, but with purchasing power parity heading for around R13.55/$1 by the end of 2019, we think a rand around current levels is a reasonable base case. This will be fairly neutral for the SA market. The average for 2018 was R13.30/$1, so there is already a positive earnings driver in 2019 for companies with offshore earnings.

Chinese gaming approvals:

The stall in gaming approvals last year had a devastating effect on Tencent and, consequently, on Naspers. However, gaming approvals in China appear to have re-started and the market will be following Tencent approvals closely in the short term.

Then there's always the additional list of worries:

Brexit is a headache and oil is always a factor (higher prices are good for oil companies, lower prices are good for inflation and growth potential), Italian debt levels and growth is also an issue.

It is worth reflecting on 2018, which was a year dominated by bombs.
12 Top-40 SA companies declined by over 25%, many for reasons which were company specific and unrelated to normal macro-economic factors. These companies account for the majority of the decline in the market in 2018. This is shown in Figure 3 on the following page.

SOUTH AFRICAN EQUITIES

>CONTINUED

Figure 3: 2018 total returns for large SA-listed shares

Source: Bloomberg, Anchor

	Total return (%)	Company-specific reason for move
Anglo American Platinum Ltd	55.0	
Anglogold Ashanti Ltd	42.2	
Anglo American Plc	32.2	
BHP Group Plc	28.5	
Old Mutual Ltd	18.1	Unbundling
Nedbank Group Ltd	12.9	
Netcare Ltd	9.2	
Clicks Group Ltd	7.6	
Spar Group Ltd	5.9	
RMB Holdings Ltd	4.4	
Mondi Ltd	4.3	
Mr Price Group Ltd	3.7	
Capitec Bank Holdings Ltd	3.6	
Mondi Plc	2.4	
Sasol Ltd	1.9	
Firstrand Ltd	1.7	
Old Mutual Plc	1.1	
Life Healthcare Group	0.1	
Exxaro Resources Ltd	-0.3	
Redefine Properties Ltd	-0.8	
AVI Ltd	-1.6	
Truworths International Ltd	-2.4	
Bidvest Group Ltd	-2.5	
Vodacom Group Ltd	-3.4	
Standard Bank Group Ltd	-4.1	
Sanlam Ltd	-4.9	Massive investment in Morocco
Absa Group Ltd	-5.1	
Sappi Ltd	-6.8	

	Total return (%)	Company-specific reason for move
Investec Plc	-6.8	
PSG Group Ltd	-7.6	
Growthpoint Properties Ltd	-8.8	
Bid Corp Ltd	-10.2	
Woolworths Holdings Ltd	-11.9	Poor Australian performance
The Foschini Group Ltd	-12.0	
Shoprite Holdings Ltd	-12.1	
Discovery Ltd	-13.0	
Glencore Plc	-13.0	DRC issues
Richemont	-14.2	
Remgro Ltd	-15.4	Widening of discount
Naspers Ltd	-16.0	Chinese online gaming approvals
RMI Holdings	-18.3	
Reinet Investments	-19.4	US tobacco legislation
Hyprop Investments Ltd	-25.1	
Barloworld Ltd	-25.9	
Imperial Holdings Ltd	-27.6	
MTN Group Ltd	-31.3	Nigerian government issues
Tiger Brands Ltd	-38.8	Listeriosis
British American Tobacco Plc	-40.0	US tobacco legislation
Mediclinic International Plc	-42.5	Swiss, Dubai legislation
Nepi Rockcastle Plc	-43.5	Accused of share manipulation
Intu Properties Plc	-45.8	UK retail property meltdown
Aspen Pharmacare Holdings Ltd	-50.5	Slow European growth, high debt
Resilient Reit Ltd	-53.9	Accused of share manipulation
Fortress Reit Ltd-B	-61.4	Accused of share manipulation

What Figure 3 above reveals is that, at a level below the index, there are many shares that have plummeted and offer attractive entry points. Of the shares with large declines in the table above, Aspen, MTN, Rand Merchant Investment Holdings (RMI), Naspers and Discovery look enticing to us.

2019 is not without its risks in SA, but if we can sustain the current path and global markets play ball then the outcome could be positive and 2019 could be the year to get equity returns back on track. Investors should recall the 50%-plus rise in domestic counters in December 2017/January 2018 when confidence peaked. This is the optionality that exists in markets and the reason to stay invested over time. As always, we will be navigating with caution, alert to changes in the outlook.

SOUTH AFRICAN BONDS

The bond market started 2019 on a better footing than last year. The yield on the R186 stood at 8.95% at the beginning of January 2019 compared to 8.60% at the start of 2018. Overall, the bond market sold-off by just over 0.3% in 2018, with the R186 ending the year at 8.95%, having stretched to highs of 9.38% and lows of 7.89%.

Most of the volatility in 2018 can be attributed to both global factors that affected EMs in general and specific domestic factors. The US-China trade war saga dominated headlines which led to risk-off sentiment and a widening of credit spreads, while global interest rates, particularly those in the US, continued to rise, increasing EM risk premiums and reducing investor appetite for EM assets. This led to the EM asset class, including SA bonds, having to absorb the brunt of the price decline.

On the local front, we saw the SA economy entering a technical recession in 1H18, which triggered a sell-off in the bond market. The downturn in the SA economy coincided with economic stability in other EM economies, such as Turkey and Argentina, exacerbating the oversold position in SA bonds.

While we expect this volatility to continue during the course of 2019, we believe it will be in favour of EM assets with the SA markets benefitting. We expect the trajectory of global growth and global policy decisions to be the primary factors to stir the SA bond market in 2019, while local inflation expectations, the pace of the SA Reserve Bank's (SARB's) rate-hiking cycle and stability of the current account deficit will be secondary factors to impact the SA bond market.

On the local front, inflation and the fiscal deficit continue to be the major causes for concern on the bond market. The major risk to the inflation trajectory is rising electricity tariffs and food inflation. We expect inflation to remain within the 3%-6% band for 2019 averaging 5.3%, while reaching the higher end of the spectrum during 1H19, with at least one interest rate hike assumed for 2019.

While we expect this volatility to continue during the course of 2019, we believe it will be in favour of EM assets with the SA markets benefitting.

We further expect rating agencies to take centre stage in 2019, particularly if there are no signs of improvement in the fiscal deficit following the budget speech and the election. Taking into consideration the aforementioned factors, our fair-value models continue to show the SA benchmark bond at 8.75%. The fair-value model assumes a fair value for the US bond of 3%, inflation differential between the US (2.2%) and SA (5.7%) of 3.5% and the credit default swap (CDS) spread of 2.25%. Given our fair value for SA bonds, we expect a twelve-month return of 10% in bonds that is comprised of 8.95% interest carry and 1.05% capital gains.

SOUTH AFRICAN LISTED PROPERTY

For the SA listed property sector, 2018 was a year to forget. But, as we look forward to 2019 and pick up the pieces, the events and themes of the past 12 months are important components in helping navigate the asset class and forecasting returns with some measure of confidence.

The magnitude of this rebasing and derating is dramatic and helps to frame the outlook going forward. In retrospect, the major factors at play were:

- The media reports around the Resilient stable which at the beginning of 2018 accounted for 42% of the benchmark index.
- South African consumers were under intense pressure, retailers suffered as a result and the dynamic changed between landlord and tenant as property companies had to start cutting deals to keep vacancies down.
- Forecast growth in distributions payable were therefore revised downward quite sharply. This “fuel supply” to the sector, which investors were always willing to effectively capitalise on in advance, fell off a cliff as confidence was lost.

This meant that the new, and higher, yields that the companies were trading at across the board did not allow equity to be raised, further impinging growth prospects in a “unvirtuous” cycle.

As we look forward, property fundamentals will become more important. The most critical of these will be the confidence in forecasting distributions that property companies can pay on a sustainable basis going forward. Our best one-year forecast suggests that the forward yield available to investors at the benchmark level will be 9.6%. This is 0.7% higher than the yield on the 10-year SA Government Bond and a level that has not been seen for many years (since the early 2000s). This yield is still forecast to grow, although at a level that is around the forecast inflation rate of 5%, and not the growth rates of 7%-9% to which the sector had become accustomed.

Further, within the overall “benchmark” picture, it is important to note that yields and growth rates vary considerably, and the dispersion is mostly caused by specific factors that relate to certain companies. So, while for example it is possible that local companies Arrowhead, Rebosis, Delta, Texton and Accelerate will all yield over 15%, there is forecast risk to this based on stock-specific circumstances. It is also possible that the calculated 12M distributions may not grow for 2-3 years. Offshore focused property companies like MAS Real Estate and Nepi Rockcastle on the other hand have lower yields (around 7.5%) but greater growth prospects in their chosen geographies, specifically Eastern Europe.

A conclusion and asset allocation to the sector has to be based on the return prospects available within the environment in which the asset class operates. With many factors to choose from we highlight what we believe to be the two most important ones below:

1. The de-rating in the listed sector has made yields more attractive than income alternatives such as government bonds.
2. There has been a large dislocation between the cap rates where physical property is being valued in SA and where yields are on listed counters. We believe this situation will normalise over the next 2–3 years and will gravitate towards physical yields of 8%-10%.

For the next 12 months we use the benchmark yield of 9.6%, the forecast growth rate of 4.5%, which we believe investors will pay for as confidence increases. Our overall forecast return is therefore 12%–14%. Because of risk factors and potential outflows from the sector after a poor 2018 we remain at a neutral weight.

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.

The rand vs US dollar exchange rate is one of the world's most volatile currency pairs

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.

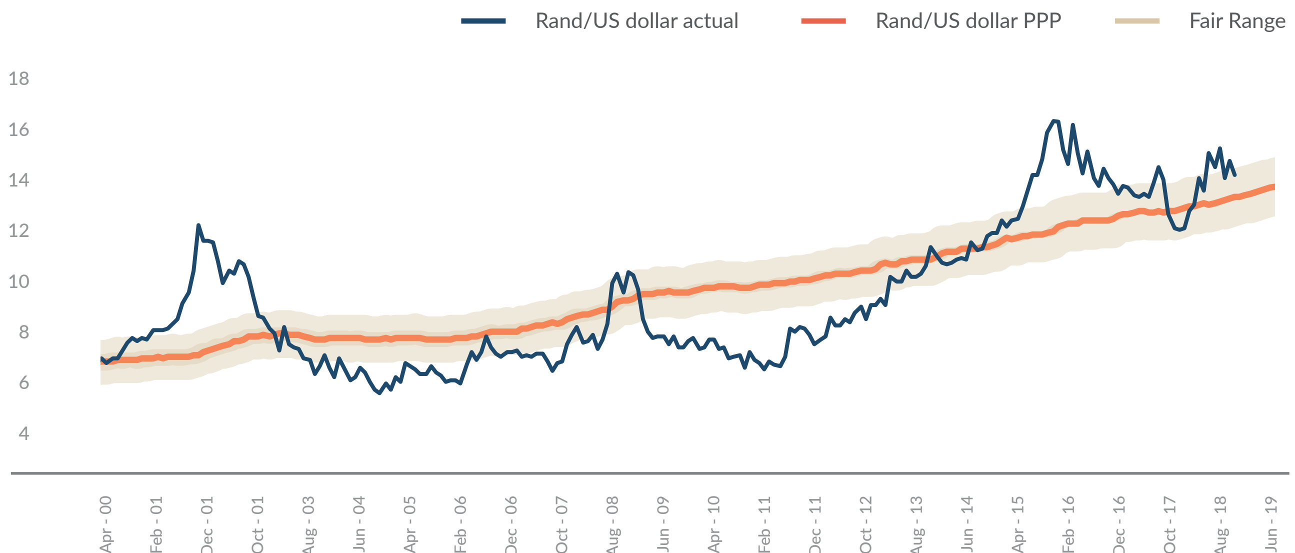
Our PPP-modelled value for the rand vs US dollar at the end of the next 12 months is R13.55/$1. We apply a R2.00 range around this to get a fair value range of R12.55-R14.55/$1.

In the context of an improving EM scenario, we would realistically expect the rand to drift towards the middle of the range.

We note that the rand ended last year at R14.35/$1, which is within our fair-value range. Therefore, whilst we are positive on the prospects of the rand to recover a little further, the movements might well be muted until we see a dramatic improvement in global EM sentiment. For modelling purposes, we have used the R13.55/$1 midpoint of our range.

Figure 4: Actual ZAR/$ vs ZAR PPP Model

Source: Anchor, Thomson Reuters



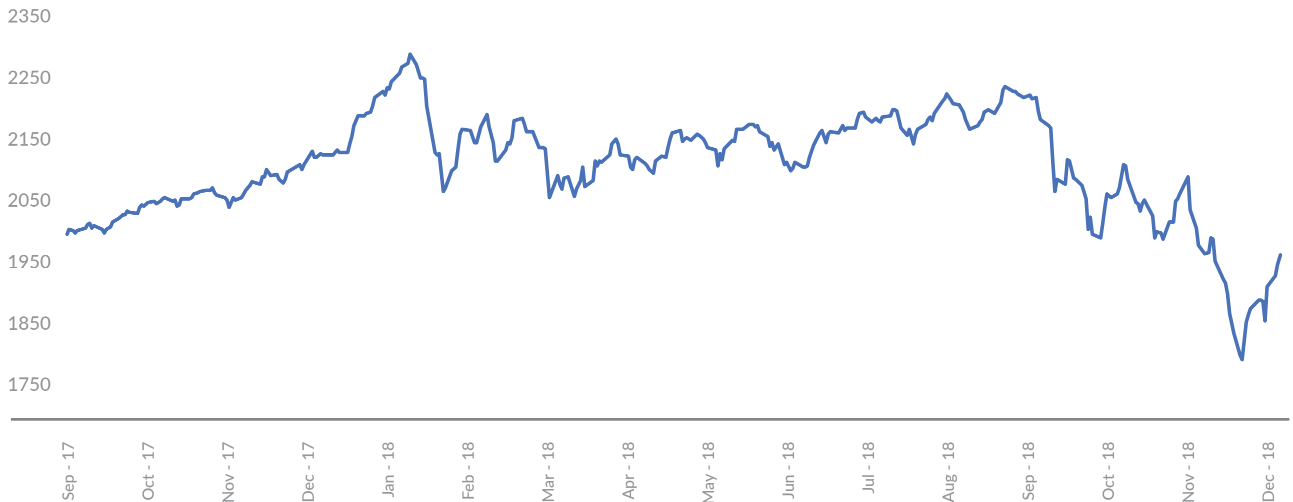
GLOBAL EQUITY MARKETS

We believe that global equity markets are pricing in a more negative economic scenario than is likely to materialise. After a c. 14% drop in the MSCI World Index in 4Q18, this index delivered a negative 9% US dollar-denominated total return for last year. With a lower base set for 2019, we expect attractive returns from global equity markets for the New Year.

Giving percentage projections for arbitrary calendar periods is an exercise in futility, but for what it is worth we think a 10%-15% US dollar total return for 2019 is possible. This is similar to the consensus view of the global investment houses, most of whom were caught off guard by a distressing 9% drop in the S&P 500 in December – its worst month in ten years. In a specific time period, returns could vary markedly from these numbers, but what we do know is that we are able to identify a portfolio of attractively priced, high-quality growth shares that are worth owning over time.

Figure 5: MSCI World Index performance, September 2017 to date

Source: Anchor, Thomson Reuters



Historically, a reasonable expectation of US dollar equity total returns over time was in the region of 8%. It is interesting to note that total returns from the S&P over the past four years have only been around 5.5%. This implies that the market has not become euphoric and the current bull market, albeit long in duration, has seldom taken shares well beyond fundamental values. This has made it more sustainable than in the past.

Global growth prospects and the related policy responses from central banks are typically the biggest driver of stock markets. While growth is likely to slow in 2019, we still believe a +/-3.5% GDP growth rate in 2019 is sufficient to drive reasonable equity earnings growth, yet market behaviour seems to suggest a far worse outcome. We think they are out of kilter, presenting an opportunity.

Global growth prospects and the related policy responses from central banks are typically the biggest driver of stock markets

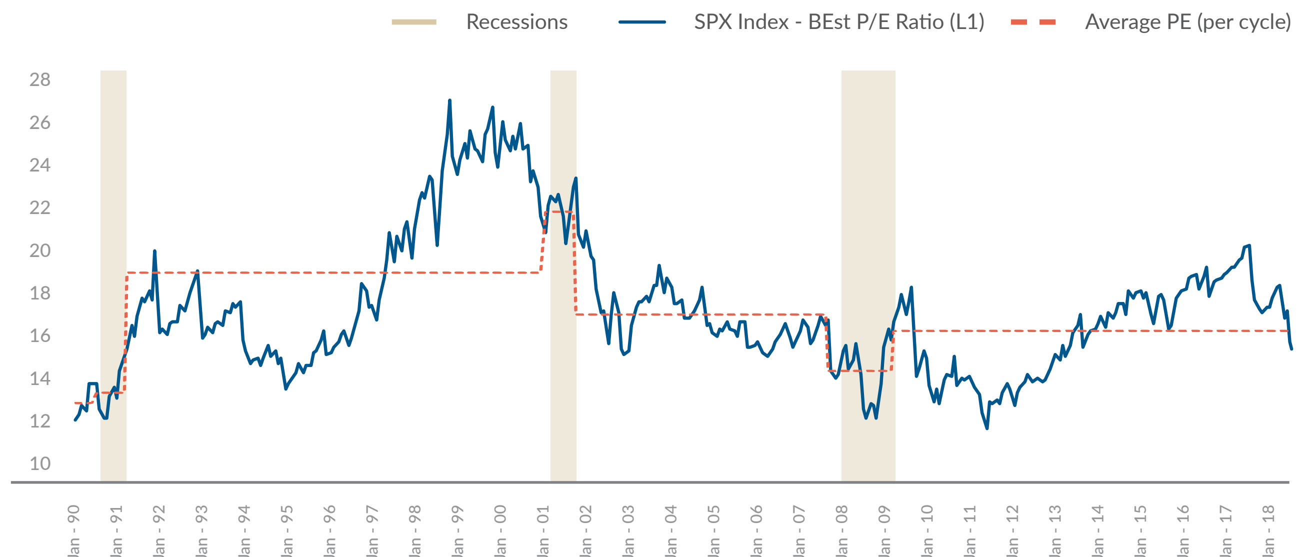
We have outlined a few factors below which we believe will dictate equity market returns in 2019.

VALUATIONS

After a year of negative returns accompanied by positive earnings growth, markets are dramatically cheaper than they were this time last year. The extent of the derating varies across the different markets but US markets, as an example, have seen their rating drop by around 30% (-5% return and 25% earnings growth). Although one could argue that the market was expensive a year ago (with a lot of the earnings growth "once-off" in nature due to Trump's tax cuts), expectations for 2019 are still for positive US earnings growth of around 6%. This implies a 12-month forward P/E multiple of 14.6x, which is the cheapest in six years.

Figure 6: Market earnings multiples for the last three economic cycles

Source: Anchor, Thomson Reuters



US ECONOMIC GROWTH

There are varied views regarding the growth outlook for 2019 and it is certain to slow from 2018's sugar-rush 3.1% growth. Growth is likely to be just under the 2% level – which is probably the medium-term sustainable growth rate. We certainly do not expect the US to go into a recession in 2019. This level of growth is sufficient to sustain reasonable equity market returns.

For now, all evidence points to an economy that is in very good shape and the longer that continues, the more supportive it should prove for equity market valuations.

US INTEREST RATES

The US Federal Reserve (Fed) has changed its message recently, indicating it is willing to be more accommodative if economic growth slows. Inflation has also continued to remain moderate and the decline in oil prices will assist this metric. Our expectation is that the Fed will hike once or twice more (25bps each time) in the year ahead but, based on slowing economic growth, it will then pause and wait for further signs from the economy. Historically, this has led to a weakening of the US dollar which has been generally positive for risk assets and particularly EMs. While the backdrop for EM investors was ghastly last year, the stars could well be aligning for an environment where EMs leads the charge.

TRADE WARS

Undoubtedly, the escalation of trade wars throughout last year has weighed on investor risk appetite and for good cause – recent data out of China has shown a marked slowdown in economic growth, which is largely being attributed to uncertainty around trade. As the second-biggest economy in the world and having contributed roughly 50% of global growth after the global financial crisis (GFC), China is crucial to the global growth outlook. With trade talks between the US and China currently underway, we believe that sanity will prevail. This would come as a welcome relief and should be a major boost to equity markets around the world. Once again, EMs are likely to benefit the most from this outcome.

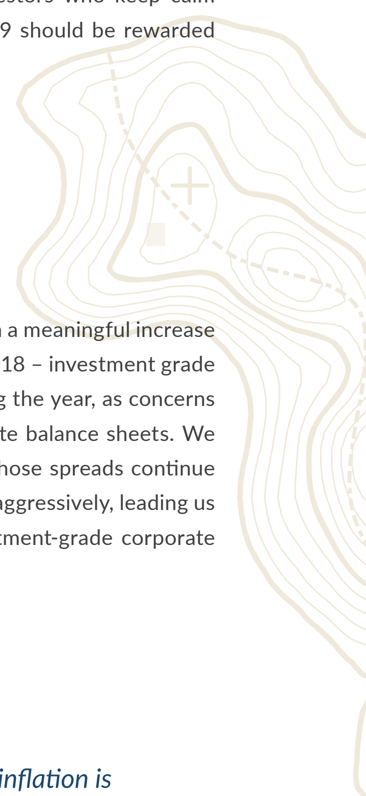
EUROZONE

The eurozone has been, and remains, somewhat of a basket case over the past five years. Any sign of positive economic growth has been overshadowed by the populist rhetoric that has emerged from certain countries in the region. The latest to join the fray halfway through last year was Italy and, unlike Greece a few years before, the Italian economy is the fourth largest in the zone so any stress to its balance sheet could well send shockwaves across the region.

Outside of this, Brexit is an ongoing saga and two-and-a-half years on it seems as though we are neither closer to knowing what the outcome of Brexit is likely to be, nor the ramifications thereof.

CONCLUSION

2018 put most investors in a bad mood and levels of anxiety are high. However, global markets are around 30% cheaper than they were a year ago and many of the headwinds are capable of being addressed by political leaders. We believe it would be in their interests to act in a manner that would be positive for reasonable economic growth. In our view, markets are acting with extreme risk aversion and are discounting an outcome worse than what will materialise. The prospects for a positive 2019 have improved given the sell-off in the last quarter of 2018. EMs could outperform in this scenario and this will be positive for SA. Current conditions are conducive to volatility, but we believe that investors who keep calm heads and stay invested through 2019 should be rewarded with meaningful returns.



GLOBAL BONDS

Over the course of the fourth quarter of 2018, financial markets changed their view on the future path of US interest rates. In September 2018 markets were pricing in expectations of two interest rate hikes in 2019 (both in the second half of the year). However, by the end of December that expectation was much closer to no hikes in 2019. Also, over the course of the last quarter, US 10-year bond yields dropped about 0.4% as a flight-to-quality pushed yields lower. All this has resulted in a significant flattening in the US yield curve. Based on expectations of no rate hikes during 2019 and a term premium of around 0.4% at this stage of the cycle, we come to a fair yield on US 10-year bonds of around 2.8%.

As a sanity check, we take a two-pronged approached to forecasting bond yields. The second approach uses inflation as a key input given the significance of that variable in determining interest rates. Forecasting the path of inflation is tricky, but we find the most reliable forecast to be a combination of the current inflation rate (inflation tends to be sticky) and the aggregate of professional forecasters. That combination suggests 2.3% inflation in the US for 2019. Investors, during this most recent cycle, have demanded a real return (i.e. return in excess of inflation) of around 1% to buy US 10-year bonds during the quantitative easing (QE) era, giving us a 3.3% fair value based on that model.

In aggregate, the two models suggest a fair value US 10-year bond yield of 3%, implying a total return for US 10-year government bond investors of 0.6% in US dollar terms in 2019. For corporate bonds, we've seen a meaningful increase in credit spreads over the course of 2018 – investment grade bond spreads rose about 0.65% during the year, as concerns mounted about the health of corporate balance sheets. We think it's reasonable to assume that those spreads continue to drift higher, though perhaps not as aggressively, leading us to a return expectation for US investment-grade corporate bonds of around 1% for the year.

Forecasting the path of inflation is tricky, but we find the most reliable forecast to be a combination of the current inflation rate and the aggregate of professional forecasters.

Risks to our forecasts come from a sharper-than-anticipated unwind of QE, which would likely lead to a very negative outcome for bonds. A faster-than-expected deterioration of global growth would also likely lead to an inversion of the yield curve, which would result in a very positive outcome for bond investors.

GLOBAL PROPERTY

Global real estate investment trusts (REITs) weren't spared in the year-end sell-off and the FTSE/EPRA/NAREIT Index of DM REITs ended the year down around 5%, despite YoY dividend growth of c. 8%. The forward dividend yield on that index (at 4.4%) is now as high as it's been since the GFC. We had previously suggested that a forward yield of around 4.3% seemed fair given the growth prospects for global REITs and the challenges still facing one of the largest sectors (retail).

We believe a reasonable total return expectation from global REITs is 9.3% in US dollar terms

The derating in REITs was fairly concentrated. In the US, most sectors fared well and it was really only hotel and resort REITs that sold off meaningfully over concerns of reduced corporate spending. Outside the US, the biggest drawdowns were in Europe and the UK, with the worst returns coming from the retail REITs. In the UK, retail REITs have major challenges – Intu's price collapsed after a consortium of potential suitors withdrew their bid; UK malls still seem slightly behind the curve in adjusting to the challenges from online retail; and Brexit uncertainty continues to linger in the background. UK issues also impacted European REITs. Europe's largest REIT, Unibail-Rodamco-Westfield, exposed itself to UK retail through its recent transaction to purchase Westfield's assets.

The spread between US 10-year bond yields and REIT dividend yields is as wide as it's been in over two years, although we think a slightly higher 10-year bond yield will help to bring that down. So, with valuations around levels we feel are appropriate, we believe a reasonable total return expectation from global REITs is 9.3% in US dollar terms, made up of 4.3% in yield and 5% in earnings growth.

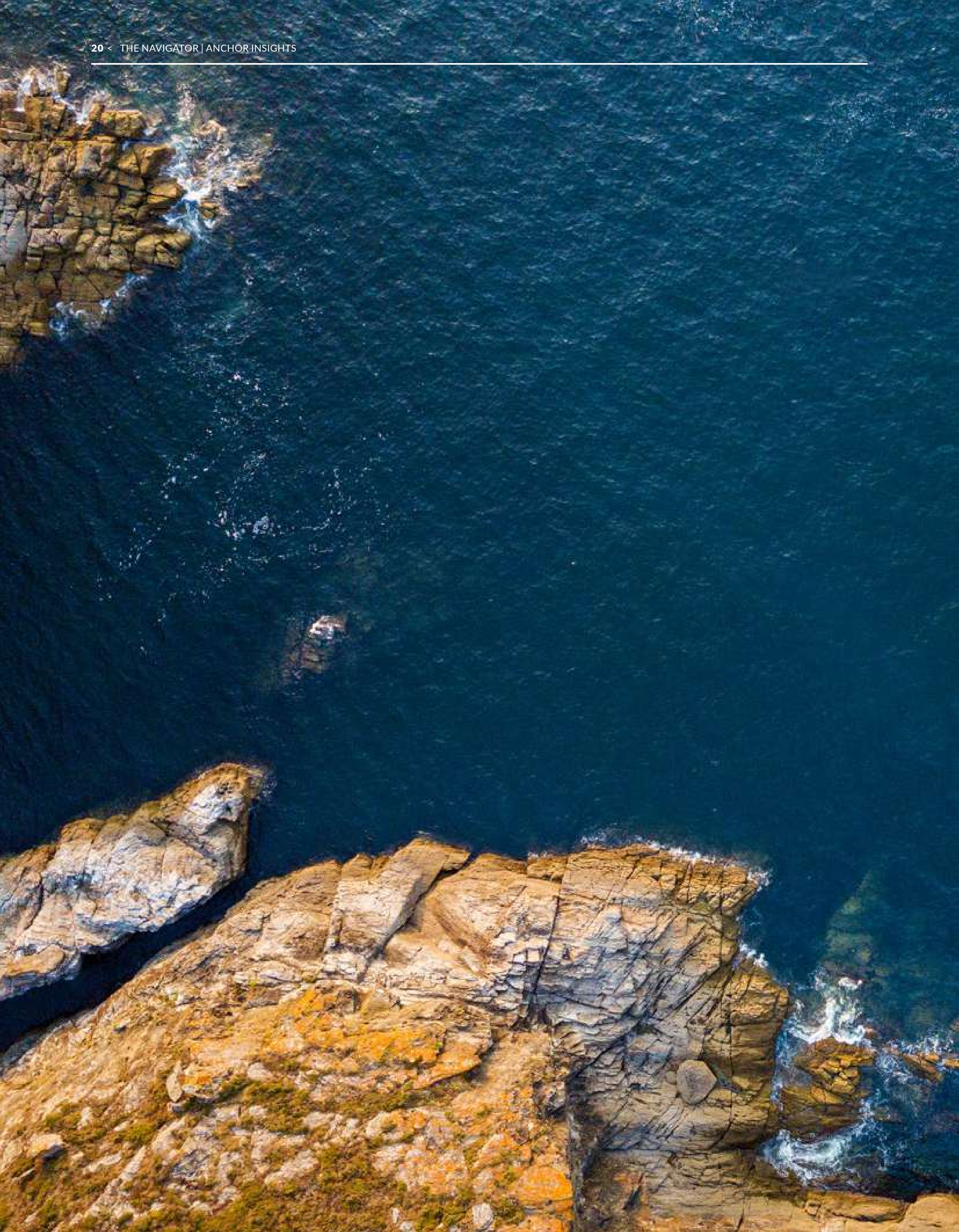
Expected Returns on Underlying Assets

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

Equity	PE1	E2 g (%)	Exit PE	Div (%)	Return	ZAR (%)	ZAR Return (%)
Local Equity	11.9	12.0	12.0	3.4	16.3	-	16.3
Global Equity	13.8	6.0	14.5	2.6	14.1	-5.6	8.6
Developed Markets	14.8	5.8	15.5	2.5	13.3	-5.6	7.7
Emerging Markets	11.3	6.5	12.0	2.9	16.4	-5.6	10.8

Bonds, Property & Cash	Yield (%)	Capital (%)	LC Return (%)	ZAR (%)	ZAR Return (%)
BONDS					
Local Government Bonds	8.8	1.1	9.9	-	9.9
Global Government Bonds	2.7	-2.1	0.6	-5.6	-4.9
Global Corporate Credit	3.9	-2.8	1.1	-5.6	-4.5
PROPERTY					
Local Property	9.8	2.2	12.0	-	12.0
Global Property	4.3	5.0	9.3	-5.6	3.7
CASH					
Local	7.3	0.0	7.3	-	7.3
Global	1.3	0.0	1.3	-5.6	-4.3

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.



ANCHOR INSIGHTS

In this section, staff from across Anchor provide insights into our thinking, strategy and our view of the world. This quarter: Peter Armitage asks the question as to what investors should do at a time of sustained very poor investment returns; Nolan Wapenaar looks at the options available to the SA government in its attempts to get Eskom back on track; Seleho Tsatsi gives an overview of the music streaming industry and its emerging oligopoly; Martin Smith discusses private client investing made easy; and lastly, Sandy van der Zanden advises on how to best achieve a secure retirement in an uncertain world.

ANCHOR INSIGHTS

My returns have been poor – what now?

Written By:

PETER ARMITAGE
CEO and Co-CIO

We have just lived through close to the worst 4-year period on the JSE in the past 25 years – with a compound return of only 4.5% p.a.

At a time of sustained very poor investment returns, some history lessons are needed to keep the faith.

Asset classes behave differently over time and riskier assets are more volatile, which investors have to stomach if they want an inflation-beating return over time. The frustration over the last few years has been that cash has delivered a similar return (after tax) to equities, causing investors to question the merit of equity investing.

This has also resulted in portfolios with low bond weightings underperforming inflation.

So what should investors do now?

A good place to look for answers is the long-term return of asset classes. This is shown in Figure 1 below:

Figure 1: Annualised returns by asset class

Source: Bloomberg, Anchor

TO END DECEMBER 2018	ANNUALISED RETURNS					
	1 Year (%)	3 Years (%)	5 Years (%)	10 Years (%)	15 Years (%)	25 Years (%)
JSE All Share	-8.4	4.4	5.9	12.7	14.8	N/A
MSCI South Africa	-12.0	4.5	6.0	11.9	14.0	12.6
JSE Bond Index	7.7	11.1	7.7	7.7	8.6	N/A
JSE Property	-25.2	-1.2	5.6	11.9	16.0	N/A
SA cash	6.8	6.9	6.5	6.3	7.1	N/A
S&P 500 Index (US$)	-4.4	9.2	8.5	13.1	7.8	9.1
S&P 500 Index (Rands)	11.0	6.6	15.5	18.0	13.4	15.5
Global Bond Index (US$)	-1.2	2.7	1.1	2.5	3.3	4.7
Global Bond Index (Rands)	14.1	0.2	7.9	7.3	8.9	11.0
Global Property (US$)	-4.8	3.4	6.4	11.3	6.2	5.3
Global Property (Rands)	10.5	0.9	13.3	16.1	11.8	11.5
R/$ exchange rate	-15.9	2.6	-6.6	-4.5	-5.2	-5.9

Over the past 3 years, equity returns have been poor (both local and global in rand terms), property returns have been negative and the rand has strengthened by 7.6% against the US dollar. The past year has been a disaster for equity assets across the board – unless you were invested offshore and measured your wealth in rand terms.

However, looking at longer term annualised returns, the answer seems obvious: equity and property is where returns are made and bonds and cash should be mixed with these to diversify, reduce volatility and lower the risk over shorter time periods. However, the last few years have been the opposite and 2018 was a particularly unpleasant ride. The natural emotional response to outcomes for the last few years is to take refuge in cash – "at least you can't lose your money".

However, to take this approach after a period of poor equity returns is always the wrong answer and the long-term outcome is a guaranteed return below inflation (after tax). Investors always need to take a long-term view and can be confident that long-term trends will continue, and they will diverge from these in shorter-term time periods.

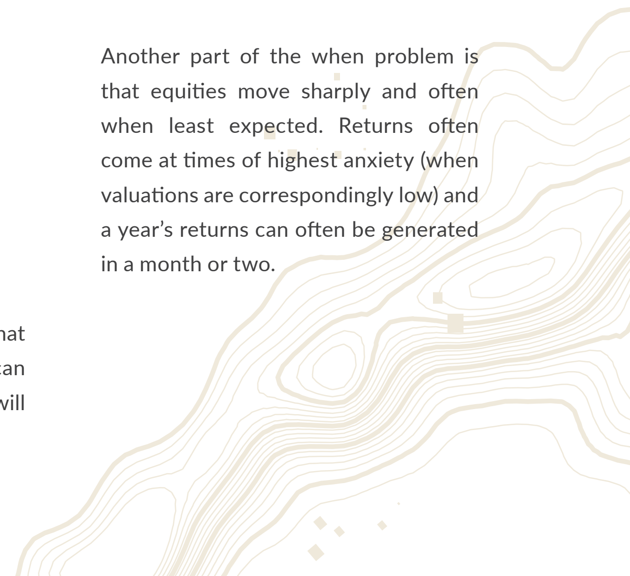
Global GDP will continue to grow at 2%-4% p.a. for the next 10 years. Markets will be cyclical and volatile, but big global companies will grow their earnings at 5%-8% in US dollar terms p.a. over the next ten years and these companies will pay out dividends which will increase that return by 2%-3% p.a. Companies will get cheap and expensive but, over time, share prices will grow in line with these earnings. That 7%-11% p.a. growth in dollar terms is what has been delivered for the past 25 years and one can be fairly certain that this will be repeated in the next 25 years.

Looking at longer term annualised returns, the answer seems obvious: equity and property is where returns are made and bonds and cash should be mixed with these to diversify

What investors will have learnt is that almost no investment professional can tell you with certainty when this will happen and what will happen in the short term – there wouldn't be 200 asset management companies and 10,000 advisors in South Africa if any one consistently got it right. We all rely on history to a certain extent and returns over the past four years have been very poor by historical standards.

A logical response to the information provided to add value to your long-term return is to increase the proportion of asset classes which have performed poorly over a three-year period and likewise to take profits on those that have flourished. Right now that means more equities and, in SA, more property as well – although the SA 2018 property return had more to do with one basket of related companies than the market as a whole.

Another part of the when problem is that equities move sharply and often when least expected. Returns often come at times of highest anxiety (when valuations are correspondingly low) and a year's returns can often be generated in a month or two.



One naturally wants to be invested in equities only when it feels comfortable – but that approach will see an investor deliver a much lower return over time. It's mostly too late when it feels comfortable. Stay invested in quality companies that will grow their earnings over time, allocate capital smartly and earn a high return on the capital that they don't return to investors.

We then need to consider our situation as South Africans, with a rand that fairly predictably depreciates at 4%-6% p.a. over the long term – that implies a rand vs US dollar exchange rate of R25/$1 by 2030. Looking at Figure 1 above, when investing in rand, a high-quality global equity portfolio is a pretty compelling proposition. JSE returns sometimes compensate for SA's higher inflation rate (it has over 15 years), but it certainly makes sense to diversify out of just SA equities.

One also has to take SA political risk into account (although US President Donald Trump's antics make our politics relatively more tolerable). Again the answer is to diversify out of any one specific risk.

One positive aspect of the SA investment environment is that it is easier to earn a real low-risk yield than in offshore markets. Cash beats inflation by around 2% (at 6.8%) and bonds by 4% (at c. 9%). This is justified by the higher risks, but the returns are there nonetheless. So, while equities are essential for longer-term returns in SA, cash and bonds are a comfortable parking bay.

There will always be calamity headlines, new risks emerge and subside on Bloomberg every day, but over the long term the pattern is fairly predictable.

The sermon above might be cold comfort for investors who need sustained inflation-beating returns in the short term. It is here where a financial advisor can guide you through the shorter-term anxieties and pressures, ensuring you don't act emotionally to reduce your long-term return.

ANCHOR INSIGHTS

What do you do with a problem like Eskom?

Written By:

NOLAN WAPENAAR
Chief Investment Officer

Barely a week goes by that Eskom isn't mentioned in the press for all the wrong reasons. The state owned enterprise (SOE) suffers from a litany of problems, including:

- The inability to produce sufficient and reliable power for SA;
- Old power stations that are suffering from neglect of maintenance;
- A business model designed in the 1980s that has not adequately evolved to take into account the new challenges facing a modern power utility, such as adjusting to power supplied by renewable producers;
- An unsustainable capital structure and debt load;
- The inability to profitably produce power; and
- Being incapable of claiming payment from municipalities for the power that is actually delivered.

There are no easy fixes to this situation and, without a doubt, all potential solutions will involve significant costs in terms of financial and job losses.

The question really is about who will bear these costs. For example, one suggestion is that the National Energy Regulator of SA (NERSA) grants the parastatal significant electricity tariff increases. This has the benefit of saving jobs at Eskom, however, it comes at the expense of jobs in the mining companies where some shafts are certain to become unviable. The tragic moment has unfortunately arrived where we can shift job losses around, but we cannot avoid them.

Similarly, the moment has arrived where financial losses have become a reality. We can charge citizens excessively for electricity, making everyone pay their share of the loss, we can ask pension funds to write down their assets, or National Treasury can assume some of the liability, effectively plunging the country into true junk status and removing SA from the all-important global bond indices.

Whichever path is chosen there can be no doubt that someone is going to pay in order to fix Eskom's broken balance sheet. We have unfortunately seen this movie all too often in SA. An SOE manages its operations poorly, often with nefarious intent, the inevitable financial disaster materialises and the SOE wraps itself up in our national flag, cries that SA cannot survive without it and secures a bailout from National Treasury.

Whichever path is chosen there can be no doubt that someone is going to pay in order to fix Eskom's broken balance sheet.

One needs to think no further than the South African Broadcasting Corporation (SABC) or South African Airways (SAA) for examples of a perpetuating cycle of poor decisions leading to bailouts and further bad decisions.

It has become clear, even recently, that an independent board at the SABC makes the government too uncomfortable, yet somehow we are to believe that a board at a future Eskom will be free from government interference when the stakes there are so much higher.

We are of the view that a bailout of Eskom without fixing the underlying root causes just perpetuates the bailout machine. The only difference being that this time the machine is big enough to wipe out the entire SA economy.

The immediate priorities in fixing Eskom are clear - we must keep the lights on while also addressing the dual challenges of a broken business model and a destroyed capital structure, while not bankrupting SA.

Many are arguing that National Treasury should assume Eskom's excessive debt load. The argument essentially being that Eskom is no longer sustainable and we should therefore add additional debt to an already overburdened state to save the parastatal. Perhaps it is just us, but borrowing money from a different source to address an excessive debt problem at both an SOE and at the national level seems to be just another way of kicking the can down the road.

Politicians have tried to run an electricity generation company and we can conclusively say that they have failed spectacularly. Let's not blithely add to our excessive national debt so that they can try yet again.

In other words, to secure funding in future, a SOE will need to be ethical, properly run and transparent. Perhaps it's just us, but we say bring it on!

We argue that the solution lies in something that is not being mentioned or discussed because it is politically very uncomfortable. A controlled default of Eskom on its debts is, in our view, the most appropriate tool for restructuring or addressing all three obvious problems - the balance sheet, Eskom's operations and the legislative environment in the country.

An Eskom default does not mean the lights go out and that it ceases to exist. Instead, it is put under curatorship with a view towards restructuring its operations, payroll and balance sheet structures. Under such a business rescue scenario it would be essential to ensure that suppliers continue to be paid on time, while the business is being fixed. This is a remarkably similar exercise to that which was undertaken for African Bank, just on a far grander scale. We are advocating that Eskom undergoes a negotiated business rescue.

Politicians are quick to talk about how a default is untenable because SA will be locked out of the debt market with a big black mark against its name forever. So, let's talk about African Bank's default in late-2014. About 18 months later, in March 2016, the restructuring was approved, and it is broadly expected that after another 36 months the company will be in a position to issue new bonds in 2019.

Let's be clear, African Bank is likely to be able to access the debt markets a mere 36 months after restructuring its debt. We therefore do not accept the political argument that Eskom will be locked out of debt markets forever, when African Bank is able to recover.

International investors shunning Eskom after a default is another argument being raised. This argument conveniently ignores the fact that African Bank bonds traded freely with buyers for its US dollar-denominated debt as soon as the restructure was completed back in 2016. In fact, Nigeria has defaulted on its offshore bonds five times and has still been able to go back to the market to secure new investors.

Getting locked out of financial markets just isn't an argument that holds water, in our opinion.

What politicians really are saying is that there will be a newfound sense of accountability in SA after an Eskom default. Financial markets will in future only make funds available to the state and to SOEs when their houses are in order. After an Eskom default we can expect that financiers will take a dim view of SOEs with poor corporate governance or opaque reporting. In other words, to secure funding in future, a SOE will need to be ethical, properly run and transparent. Perhaps it's just us, but we say bring it on!

Restructuring Eskom will be about the legislative framework as much as it will be about the SOE itself. We know from the rolling blackouts (in SA we call it "load shedding", in the US it is referred to as "rolling blackouts") in California during 2000 and 2001 that a pure free-market system also risks failure and corruption (think Enron). Instead, it makes sense for power generation and distribution to be based on a public-private partnership (PPP) model with a sensible regulatory framework. The model of generating electricity with the objective of making a loss has reached its inevitable outcome and the SA government will need to embrace the private sector in order to decisively deal with this problem.

Government has indicated that the time has come to re-evaluate the distribution model. The national electricity grid should be split from its generation operations and should be independently managed. We are of the view that this should be housed in a separate entity with private participation.

There is a massive transformational opportunity here (if the government manages this process) to give some shareholding to employees and to

empower some of those who have worked at Eskom for much of their lives. Clearly a significant portion of the SOE should be listed, just like the success we have seen with Telkom. This ensures transparency and, with good governance, will allow for future access to debt markets.

The government should also reconsider the current residential distribution model whereby electricity is supplied to municipalities in bulk and then on-sold at a markup to residents. Clearly, municipalities are benefitting from this revenue source (and from failing to pay Eskom), but perhaps allowing the private sector a role will be transformational and will also give the consumer more transparency in their electricity pricing?

As for generation, we are of the view that individual plants should be sensibly grouped together (a few at a time) and spun-off into their own generation companies - baby Eskoms if you like. Each of these will provide electricity into the national distribution grid based on an offtake arrangement, while allowing some element of both natural market forces and regulations to drive prices and volumes. Each company will create transformation opportunities and should also be listed.

A significant advantage to this model, whereby a number of power producers all supply the grid based on natural market forces, is that it allows competitors to enter the market. If the Russians want to build a nuclear plant in SA and provide power into our grid at prevailing prices, then we should welcome them (with some regulatory oversight). Taxpayers should not have to pay for the creation of the plant but, instead, we should encourage private capital to create our power sources. We should welcome with open arms the Russians to invest in our economy and produce electricity at fair prices. The issue here is just that we do not want the South African state to buy the plant from them at inflated prices and to take the power-generation risk and responsibility on behalf of citizens.

We should welcome with open arms the Russians to invest in our economy and produce electricity at fair prices.

Where does this restructuring leave Eskom's current debt holders? Well, each of the baby Eskoms should be established with a high, but sustainable, debt load (making the equity pricing attractive from a transformational perspective). Existing Eskom debt holders will also hold the debt from the baby Eskoms and the national distribution grid, either through a debt-swap mechanism or, more likely, through a pooling structure.

Debt holders will also want a portion of equity in these new companies to compensate for some of the loss that they are going to take on existing debt. Debt holders will also require some of the proceeds from listing the new companies on the stock exchange. However, make no mistake, these debt investors will likely also suffer losses of 10% to 25% to their debt investments.

The SA government has already guaranteed a significant portion of Eskom's debt. These guarantees would shift across to the debt that is issued by the baby Eskoms, leaving the holder in a position where he is no worse off on that portion of the debt. To the extent that Eskom debt is written off, this debt will then be shifted to National Treasury. This is still not an ideal outcome, but the cost will probably be less than half the costs associated with the current plan of transferring R100bn of debt to National Treasury.

As for the government's stake in Eskom, giving some of that up in order to reduce the contingent liability that is spiraling out of control seems like a massive win for National Treasury.

Perhaps, what was once unthinkable is now a bold step into a brighter future with the lights on and the economy working.

ANCHOR INSIGHTS

Tipping the music scales

Music streaming's emerging oligopoly

Written by:

SELEHO TSATSI
Investment Analyst

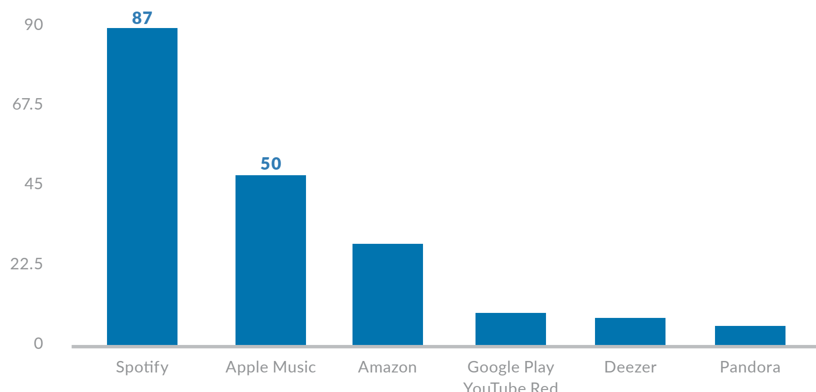
The necessity of scale has moved the music streaming market towards an oligopoly. In this note we examine the competitive dynamics which make the market challenging for new entrants. First, the music streaming market already resembles an oligopoly with only a handful of players enjoying the majority of market share. Second, music streaming platforms require scale to negotiate decent licence agreements with licence rights holders. Third, the revenue received from the streaming oligopoly has become vital to music labels. Fourth, as entrenched music subscription businesses mature, their increased proportion of longer-tenured customers should bring operating leverage via reduced marketing costs. Finally, several major music streaming platforms are not huge profit centres for their companies, meaning that their core businesses can subsidise losses that new entrants would struggle to endure.

THE MARKET ALREADY RESEMBLES AN OLIGOPOLY

The music streaming market already resembles an oligopoly. As Figure 1 shows, the three largest providers (Spotify, Apple and Amazon) enjoy a roughly two-thirds share of the market. Although some have described Spotify and Apple as a duopoly, Amazon and Alphabet (holding company of Google and YouTube) represent legitimate competition.

Figure 1: Music streaming subscribers (mn)

Source: Company Reports

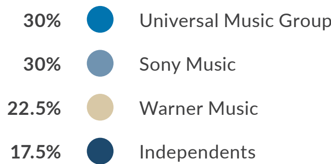


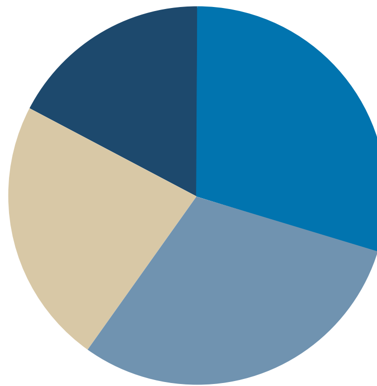
Note: Spotify and Apple have disclosed subscriber numbers while the others are estimates.

STREAMING PLATFORMS REQUIRE SCALE TO NEGOTIATE DECENT LICENCE AGREEMENTS

Figure 2: Global music market share

Source: FT, Deutsche Bank, Midia Research





Streaming platforms require licence agreements from rightsholders to stream music to their users. These platforms incur royalty costs based on a rate negotiated with music labels and other rightsholders. The high degree of concentration of rights amongst music labels gives these labels significant bargaining power. This is illustrated by the high concentration of the industry's revenue between the three major labels - Universal Music Group, Warner Music and Sony Music. These three labels constitute over 80% of the industry's revenue (see Figure 2).

This dominance is also exemplified by 85% of music streamed on Spotify being owned by either the three major labels (Universal Music Group, Warner Music or Sony Music) or Merlin, which represents many independent labels.

Given this bargaining power, streaming platforms require major scale to negotiate decent licence agreements with labels. Spotify, for example, was able to move gross margins from 15% to 25% by negotiating better license agreements with labels. This was only achievable thanks to the company's scale.

Smaller streaming companies, on the other hand, will struggle to achieve the scale necessary to be competitive.

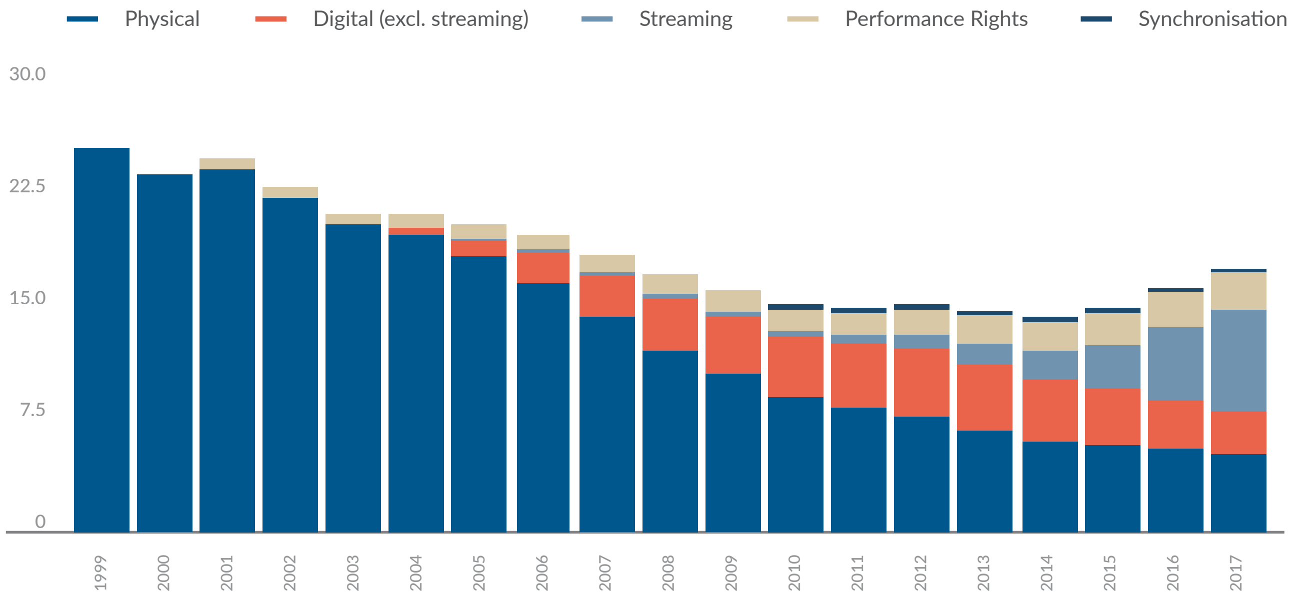
> *"It's fair to say at this point, if you're relatively small and under-capitalised, it's kinda game over for you...It's a scale business."*
>
> *- Barry McCarthy, Spotify CFO September 2018*

REVENUE RECEIVED FROM THE STREAMING OLIGOPOLY HAS BECOME VITAL TO MUSIC LABELS

The rapid growth of streaming platforms has made them vital to music labels. Not only is streaming the largest contributor to music industry revenue, it is the fastest-growing segment by some distance. Streaming has grown from 3% of global music revenue in 2009 to 38% in 2017 (see Figure 3). Physical sales remain the second-largest segment of the industry. Physical sales have relentlessly declined from $25bn in 1999 to just over $5bn in 2017. At one stage, digital downloads appeared to be the future of the industry. Digital downloads peaked, however, in 2012 at $4.4bn and have since shrunk alongside physical sales. Even with physical sales and digital downloads coming under pressure, total industry sales entered a growth phase in 2015. That growth is being driven by the streaming market, which has grown 42% p.a. since 2009.

Figure 3: Global recorded music industry revenue ($bn)

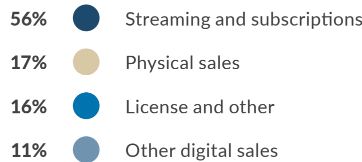
Source: IFPI

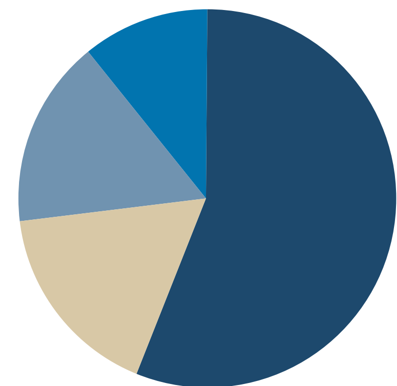


The major record labels now generate over half of their revenue from streaming services (see Figure 4), making the streaming players vital to the music labels. This has resulted in the music labels needing the streaming platforms for the revenue they provide just as much as the streaming platforms need the music labels for the labels' licence rights

Figure 4: Universal Music Group 1H18 revenue contribution

Source: Vivendi





OPERATING LEVERAGE ON MARKETING SPEND

Barriers to entry rise over time for new entrants as operating leverage improves marketing efficiency for incumbents. A music streaming platform incurs customer acquisition costs to attract new subscribers. As the average tenure of subscribers on the platform lengthens, the proportion of the subscriber base that was recently acquired and to which marketing dollars were recently devoted, falls.

The marketing cost associated with these long-tenure subscribers is lower than the marketing cost to acquire new subscribers.

This process should allow the company to achieve operating leverage with regards to its marketing costs. As Figure 1 demonstrates, new entrants will have to compete with incumbents that already enjoy a large lead in this respect.

MUSIC STREAMING PLATFORMS ARE NOT PROFIT CENTRES FOR THEIR COMPANIES

Table 1 shows that, with the exception of Spotify, these companies derive the vast majority of their revenue from non-music related businesses.

Table 1: Revenue split by firm

Source: Company reports

Alphabet		Amazon		Apple		Spotify	
Online advertising	86%	Online stores	52%	iPhone	63%	Premium	90%
Google Other	14%	Third Party Sellers	18%	Services	14%	Ad-Sponsored	10%
		AWS (Cloud Services)	11%	Mac	10%		
		Physical Stores	8%	iPad	7%		
		Subscription services	6%	Other Products	7%		
		Other	4%				

Music streaming platforms are also unlikely to become profit centres for most of their companies because the size of the music market is small, despite its cultural significance. Global industry revenue totalled $17.3bn in 2017. Compared to other sectors in which major techology firms operate, such as global advertising ($585bn) or smartphones ($458bn), the addressable market for music is tiny.

If Apple, for example, were to capture all $17bn of the music market, that would equate to only 7% of additional revenue growth for the company. Clearly, the market opportunity is not the sole motivator to enter this space.

Apple's CEO, Tim Cook, has intimated as much. The large-cap tech companies may view their streaming offerings as a way to entrench their respective businesses. While Apple may not be in music for the limited market opportunity, it most likely views it as a way to support its 1.4bn active devices in its ecosystem and increase switching costs for those users. For Amazon, music streaming serves as one of numerous value-adds for its Prime membership (we note that you must subscribe separately to Amazon Music Unlimited even if you are a Prime member) rather than a meaningful revenue driver for the company. Spotify is an exception here as it is solely focused on the music streaming market.

"We're not in [music] for the money."

- Tim Cook, Apple CEO February 2018

For new entrants, it is very difficult to compete with incumbents providing a competing service if those incumbents do not view the market as central to their own bottom line. These incumbents may use their much larger balance sheets to subsidise losses that new entrants cannot sustain for meaningful periods of time.

The music streaming market is still young, yet an oligopoly amongst providers has emerged. This note has examined the advantages of scale, operating leverage and adjacent businesses that serve as barriers to entry for incumbents against new entrants.

We are monitoring the music streaming market to keep abreast of investment opportunities for stand-alone services, such as Spotify, and to glean further insights on the larger-cap technology firms in the emerging oligopoly we have described (Apple, Amazon and Alphabet). Given the competitive advantages we have discussed, we expect incumbent firms to continue to dominate the music streaming market.

ANCHOR INSIGHTS

Private client investing made easy

Written by:

MARTIN SMITH
Portfolio Management

At Anchor we have always had an entrepreneurial spirit, with solution-focused problem solving encouraged. This is the way Anchor portfolio and wealth managers think when proposing investments and structures (where applicable) to clients. It is not a case of product-pushing or square pegs in round holes – rather we pride ourselves on providing the best, and most appropriate, financial solutions for our clients' needs, even if these occasionally require out-of-the-box thinking.

From the first meeting with a new client to the ongoing communication, we continually consider risk tolerance and appetite, time horizon, asset allocation, cashflow requirements and any special requirements (e.g. Sharia compliance or a client wanting a portfolio without mining stocks). Again, we tailor our investment decisions to each client's individual needs and focus on building a relationship with the client from day one, to ensure that we always understand a client's personal needs.

We place significant importance on maintaining this relationship because, simplistically, we believe there are two aspects to successfully managing private client funds - returns and service. As much as we like to think they are, returns are not always within our control. For example, if the Chinese government suddenly decides to limit time spent on mobile games for children (as they did in 2018), Naspers, with its c. 30% shareholding in China-listed Tencent, will be taking some pain and, consequently, because of Naspers' huge weighting on the JSE, so will our market. Service, however, is completely within our control and we take it incredibly serious.

One aspect of servicing clients is ensuring they are (as mentioned above) in the best and most appropriate investment for their particular set of circumstances. Another is keeping clients close to the investment process and educating them on why we are making the decisions we are. Experience has taught us that an informed client is a happy client and we achieve this through the frequent publication of research and ideas, as well as ongoing communication. Again, we place a great deal of emphasis on building relationships and trust with clients.

Below we highlight a few examples of options available to cater to unique client needs:

Example 1 – Maximising Tax Efficiency:

Given the recent market volatility, certain investors are understandably nervous about financial markets and have opted to leave their surplus funds in cash. When discussing this with potential or existing clients, we make mention of what we believe to be a more elegant solution than leaving cash in a bank and earning taxable interest. While still respecting the client's risk-averse stance, we have proposed investing their cash in the low-risk Anchor BCI Flexible Income Fund within the Hollard Endowment structure, where the tax rate on income and capital gains is 0%. The outcome is a marginally higher-risk profile compared to cash in the bank but, potentially, significantly higher returns over a 5-year period.

In Figure 1, we illustrate that our alternate solution could potentially yield a return 13% higher over 5 years than cash in the bank, where the interest earned is liable for income tax.

We have assumed the following:

- The BCI Flexible Income Fund has a yield of 7.5% p.a. and capital growth of 1.5% p.a..
- After fund fees of 1.3% p.a. and the Hollard Endowment platform fee of 0.99% p.a, the expected return is 6.7% p.a.
- In a money market account, investors earn 7.2% p.a. but will have to pay 45% p.a. income tax on this interest.

Figure 1: Anchor BCI Flexible Fund

Source: Anchor

INITIAL FIVE-YEAR PERIOD

HOLLARD INVESTMENT

Year	Starting Value	Capital Growth	Annual Yield	Tax On Yield	Hollard Fee	Anchor Fee	Ending Value
1	1,000,000	15,000	76,125	0	-10,802	-14,185	1,066,138
2	1,066,138	15,992	81,160	0	-11,517	-15,123	1,136,651
3	1,136,651	17,050	86,528	0	-12,278	-16,123	1,211,827
4	1,211,827	18,177	92,250	0	-13,090	-17,189	1,291,975
5	1,291,975	19,380	98,352	0	-13,956	-18,326	1,377,424
					CGT on Withdrawal		**0**
					Post CGT Value		**1,377,424**

INITIAL FIVE-YEAR PERIOD

MONEY MARKET INVESTMENT

Year	Starting Value	Capital Growth	Annual Yield	Tax On Yield	Hollard Fee	Anchor Fee	Ending Value
1	1,000,000	0	72,000	-32,400	0	0	1,039,600
2	1,039,600	0	74,851	-33,683	0	0	1,080,768
3	1,080,768	0	77,815	-35,017	0	0	1,123,567
4	1,123,567	0	80,897	-36,404	0	0	1,168,060
5	1,168,060	0	84,100	-37,845	0	0	1,214,315
					CGT on Withdrawal		**0**
					Post CGT Value		**1,214,315**

We note that the underlying investment can be changed, should the client's risk appetite return – a client can go from the cash alternative described above to 100% equity exposure within a few days. In current market conditions, we believe being nimble and creative can yield tangible results.

Example 2 – Large Single Stock Exposure:

The Steinhoff accounting scandal, which broke in December 2017, serves as a timely reminder of those risks associated with having large exposure to a single share. We often come across clients who have significant single-stock exposure where they have accrued large rand gains. This could be, for example, due to them having worked at a listed company for many years or, as in the case with a stock like Naspers, benefiting from a share's compounding returns over a long period. The client has the option to transfer a portion (or all) of the concentrated stock position into a single unit trust or a combination of funds that give them the desired and appropriate risk/return profile, as well as local/offshore split.

Section 42 of the Income Tax Act provides for rollover relief in certain share-for-share transactions, such as the transfer referred to above. The original base cost of the share(s) carries forward and the client becomes liable for capital gains tax (CGT) on the sale of the units in the unit trust(s) at a certain date in the future.

Practically, the process is fairly simple. A client exchanges the shares (e.g. Naspers) in their Anchor Stockbroking account for units in a fund held with Boutique Collective Investments. Both the cost and market value of the position are transferred into the fund position.

As the saying, made famous by US economist Harry Markowitz goes, "diversification is the only free lunch" in finance.

Example 3 – Global Diversification:

On the topic of diversification, we urge clients to externalise funds where possible – this is not only from an overall asset allocation perspective but also because the investible universe is that much greater globally, thus providing opportunities we may not have in the local market. In addition, it has never been easier to externalise clients' hard-earned South African rand. There are three ways in which an investor, in their personal capacity, can take funds offshore:

1. Through utilising their discretionary allowance of R1mn per calendar year;
2. Through applying to the SA Revenue Service for tax clearance up to a maximum of R10mn per calendar year; or
3. Through an asset swap, where a company (e.g. Anchor) externalises funds on the client's behalf. While the client has direct offshore currency exposure, the funds are essentially still viewed as rand-denominated. When the client disinvests, their foreign currency will be converted back to rand. This is more commonly used by trusts and companies to externalise funds.

Akin to a Section-42 transfer, this process is relatively simple. For clients using their allowance or going via tax clearance, they open a South African Corporate Cash Manager (CCM) account. Once the funds are transferred into this account, Anchor's forex desk does the conversion from rand into the desired currency (e.g. US dollar). The forex trade takes two days to settle, at which point we transfer the funds to the client's offshore stockbroking account. Clients utilising an asset swap follow the exact same process, except the initial rand investments are transferred to Anchor's CCM account.

The Steinhoff accounting scandal, which broke in December 2017, serves as a timely reminder of those risks associated with having large exposure to a single share.

Once the funds arrive in the client's offshore stockbroking account, those funds are invested in a share portfolio, unit trust, or combination of these. Where appropriate, we propose that clients use life wrappers when investing abroad. We make use of the Old Mutual International or Sanlam Glacier offerings. We note that Anchor does not receive any rebates from these providers but believe they are useful for South African investors, with specific reference to estate planning and situs tax.

ANCHOR INSIGHTS

Secure retirement in an uncertain world

Written by:

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Wealth Management

Discussing getting older is never easy and the possibility of not having enough assets to provide for your twilight years is just plain frightening.

It may be for these reasons that family retirement discussions often get postponed (in some cases indefinitely).

There may also be another factor at play - the silent change in the pension fund industry that has fundamentally altered how employees retire today.

WHERE DID MY GUARANTEED RETIREMENT GO?

Retirement planning currently is very different from how your parents and grandparents prepared for their retirement. The main consideration for earlier generations was making sure you were with a good company that provided a solid pension plan for its employees. The next step was to stay with the company for as long as possible to maximise the benefits at retirement. So what has changed?

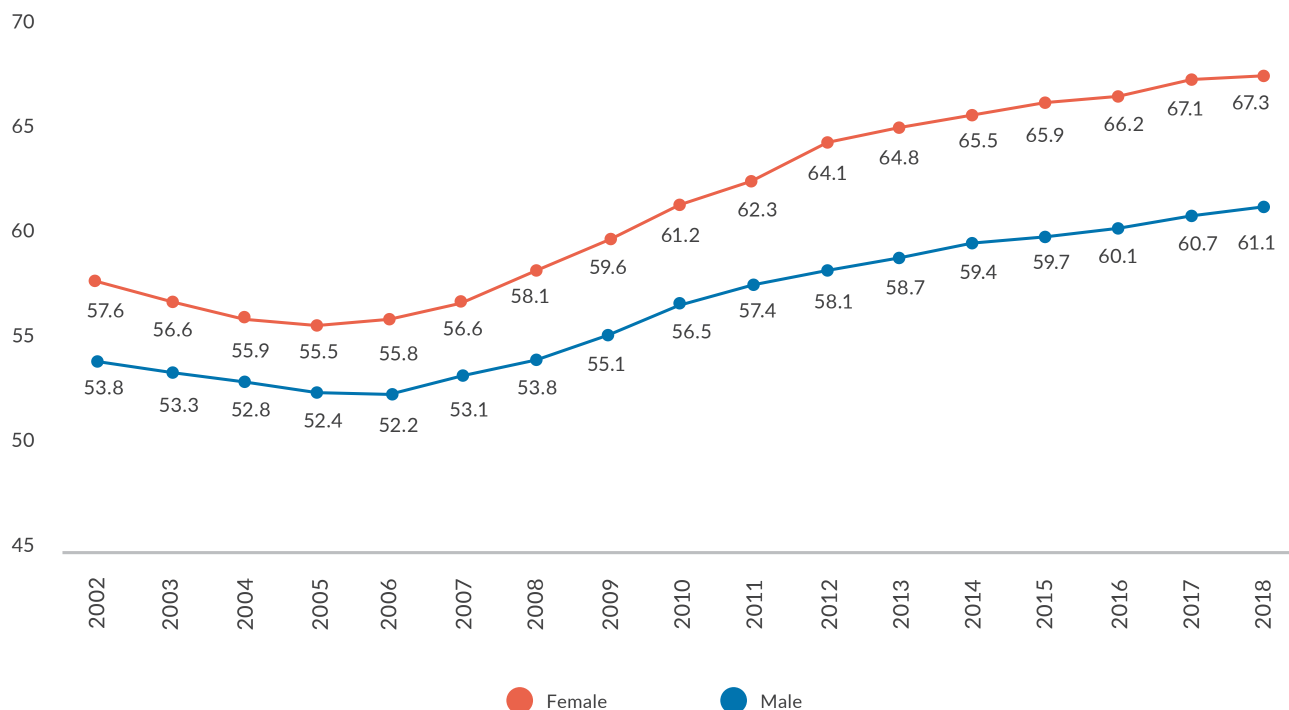
DEFINED BENEFIT VS DEFINED CONTRIBUTION FUNDS

A defined benefit fund is a fund where the benefits are stated in the rules of the fund. The benefits are usually guaranteed and don't depend on the underlying investment returns of the fund. A defined benefit fund, for example, could pay a percentage of the employee's final salary for life (and a smaller percentage could continue to pay the spouse on the death of the retiree). In this scenario, the employer bore the risk of making sure the employee had a secure retirement.

A defined contribution fund places the risk on the employee - if the investment returns are poor, or the employee lives longer than expected, they run the risk of not having enough income in their later retirement years.

Defined benefit funds were the norm at large firms in South Africa for many years. Today the closing of defined benefit funds has become a global trend with multinational companies moving away from guaranteed benefits for employees. This has given rise to the prominence of defined contribution funds - and increased uncertainty for retirees. The outcome for defined contribution fund members is that you now have to secure your own retirement as your employer is not going to do it for you. Planning and managing capital drawdowns over time is now the primary focus of most retirement planning.

Figure 1: SA life expectancy by gender over time, 2002–2018
Source: Stats SA



THE IMPACT OF LONGEVITY

We are living longer today than previous generations which is exciting, and a bit daunting as well. The life expectancy of a female South African has increased by 10 years since 2002 (see Figure 1). This means that a girl born today will statistically live 10 years longer than a girl born in 2002.

The trend of living longer is increasing internationally with improved access to medical care and the improved quality of medical treatment.

A longer lifespan is something we need to factor in when planning for retirement - you may fall short if you are only projecting retirement income to age 80. What if you live to be 85 or 90? Do you have sufficient capital to provide for over 30 years' worth of living expenses in retirement?

Living longer also means there will be a need to cover increased medical expenses down the line. Managing these requirements through your retirement takes careful planning, discipline and an ongoing review process to keep you on track.

THE DIFFERENT STAGES OF RETIREMENT

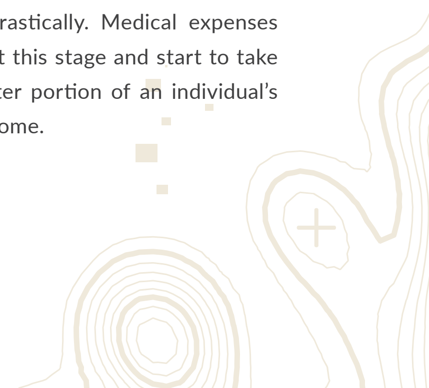
Retirement is often thought of as a single event for which we need to prepare. However, retirement is in fact a phase of life that can be broken down into two main stages – each with its own unique requirements and expectations.

The early years:

The first years of retirement tend to be mainly activity and travel focused for many retirees. Think of it as the time to tick those remaining items off your bucket list. Always wanted to travel to Paris? Fancy a world cruise? This is the time to do it (while your health and energy levels are still good). Planning and implementing these goals will usually consume most of the time and financial focus in this stage of retirement.

The later years:

As retirees get older there is a tendency to be more locally based and travel reduces drastically. Medical expenses increase at this stage and start to take up a greater portion of an individual's overall income.



THE FOUNDATIONS OF A SECURE RETIREMENT

Now that we know what retirement typically looks like, let's start with a few basic rules for peace-of-mind retirement:

1. Pay off your debt. Ideally all debts should be paid off by the time you reach retirement age.

2. Own your own home, one that preferably will take you through the different stages of retirement (this can be a stand-alone property or a retirement village etc.).

3. Have a good medical aid. Medical expenses ramp up the older you get. Make sure you are covered for any unexpected medical needs.

4. Have enough assets/income to provide for your retirement needs.

Pension funds, provident funds, preservation funds and retirement annuities all have one thing in common - the capital portion not taken in cash must be used to purchase an annuity. Provident funds allow for a withdrawal of up to 100% at retirement, while the other funds allow for a maximum withdrawal of one-third. You can decide on how much to withdraw based on your needs and the tax payable. Tax is paid according to the retirement tax table (Figure 2 below). Please double check with your tax practitioner as personal circumstances and fund specifics may change the tax treatment of your withdrawal.

Once you have taken your cash, the next step is to decide on how to provide for your retirement income.

Figure 2: Retirement tax table

Source: PKF Tax Guide, 2018-2019

Taxable portion of lump sum	Rates of tax
R0 - R500,000	Nil
R500,001 - R700,000	18% of the amount over R500,000
R700,001 - R1,050,000	R36,000 + 27% of the amount over R700,000
R1,050,001 +	R130,500 + 36% of the amount over R1,050,000

SELECTING YOUR ANNUITY

There are three options available for the remaining capital in your retirement fund.

Defined benefit pension

The Government Employees Pension Fund (GEPF), for example, is a defined benefit fund that will allow you to calculate your actual income in retirement depending on years of service, the withdrawal amount etc. Once you have made your selection this will be implemented for you and can't be amended down the line - so choose carefully!

Fixed/guaranteed annuity

These annuities are similar to defined benefit funds as you make a selection at retirement that can't be changed down the line. In effect, you give up the capital in exchange for a promise from the insurer to guarantee you income for life. When you die there is no inheritance for your family. Therefore, if you have a spouse, it is advisable to look at a joint annuity that will provide guaranteed income for both of your lives. You may also want to consider a guarantee term that will ensure that the income is paid for a minimum number of years to your dependents (if both of you die soon after starting the annuity).

Living annuity (the flexible option)

A living annuity is a structure that allows you to decide how to invest your retirement savings in a tax-free environment. You must choose between 2.5% and 17.5% of the capital as an income every year, which can be paid monthly, quarterly or annually.

The trick with a living annuity is to draw an income that will be sustainable for the rest of your life - draw too much and you run the risk of running out of money. The Association for Savings and Investment South Africa (ASISA) table (see Figure 3 below) provides some guidance on drawdown percentages in retirement, based on different investment return assumptions.

A general rule would be to keep income drawn to a maximum of 5% p.a. but this will depend on various factors including retirement age and personal circumstances.

In summary

Retirement should be viewed as a process rather than a once-off event. It is well worth your while to engage with an experienced advisor/planner to help you navigate the various choices and options specific to your own retirement plan. General principals will only take you so far - the most advantageous solution is the one that will best cater to your ongoing retirement needs.

Figure 3: Living annuity drawdown table

Source: ASISA

Years before your income will start to reduce

Annual income rate selected at inception	Investment return p.a. (before inflation and after all fees)				
	2.50%	5.00%	7.50%	10.00%	12.50%
2.50%	21	30	50+	50+	50+
5.00%	11	14	33	33	50+
7.50%	6	8	13	13	22
10.00%	4	5	7	7	9
12.50%	2	3	4	4	5
15.00%	1	1	2	2	2
17.50%	1	1	1	1	1

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Performance Summary

	FUND PERFORMANCE						BENCHMARK PERFORMANCE						
	Start date	Annualised p.a. (%)	Since inception (%)	12-month (%)	6-month (%)	3-month (%)	Dec 2018 (%)	Since inception (%)	12-month (%)	6-month (%)	3-month (%)	Dec 2018 (%)	Performance vs Benchmark (%)
UNIT TRUSTS													
Anchor BCI Equity Fund	Apr-13	10.9	81.5	-7.67	-6.8	-6.5	0.5	53.8	-10.9	-5.4	-3.8	2.6	27.7
Anchor BCI Flexible Income Fund	Jun-15	7.5	29.8	7.0	4.2	2.1	1.1	33.0	8.3	4.1	2.1%	0.7	-3.1
Anchor BCI Managed Fund	Jan-15	2.5	10.2	-5.8	-5.3	-5.6	0.4	47.7	10.2	4.7	2.3	0.6	-37.5
Anchor BCI Worldwide Flexible Fund	May-13	9.5	67.1	-0.27	-7.5	-11.0	-3.0	64.3	9.2	4.2	2.1	0.5	2.9
Anchor BCI Property Fund	Nov-15	-2.5	-7.6	-14.7	-4.1	-4.3	-0.9	-9.9	-25.3	-5.0	-4.0	-1.1	2.3
Anchor BCI Global Equity Feeder Fund	Nov-15	2.4	7.9	-0.2	-14.1	-18.7	-5.0	22.7	5.1	-4.9	-11.4	-4.0	-14.8
Anchor BCI Bond Fund	Feb-16	10.1	32.1	7.0	3.3	3.0	0.4	31.0	7.7	3.6	2.7	0.6	1.2
Anchor BCI Diversified Stable Fund	Feb-16	6.0	18.6	3.6	1.2	-1.0	0.4	14.4	1.1	-0.4	-2.0	0.3	4.1
Anchor BCI Diversified Moderate Fund	Feb-16	4.4	13.4	0.1	-0.7	-2.9	0.0	10.7	-2.0	-2.5	-3.9	0.2	2.7
Anchor BCI Diversified Growth Fund	Feb-16	3.0	8.9	-2.7	-3.0	-4.5	0.0	9.7	-3.9	-3.7	-4.8	0.3	-0.8
Anchor BCI Africa Flexible Income Fund	Mar-16	5.0	14.7	7.4	4.3	-0.4	2.5	29.1	9.3	4.6	2.3	0.8	-14.4
EQUITY NOTES & SEGREGATED MANDATES													
Anchor Equity	Jul-13	8.4	56.3	-6.7	-2.1	-3.5	1.1	52.7	-10.9	-5.4	-3.8	2.6	3.6
Growing Yield*	Jun-12	10.5	91.3	-3.2	2.0	0.0	1.1	90.2	10.2	4.7	2.3	0.6	1.1
HEDGE FUNDS													
Long Short Equity	Mar-13	6.9	47.0	-2.6	-2.6	-0.3	1.4	56.4	8.8	4.3	2.2	0.7	-9.3
Property Long Short	Jan-14	8.9	53.2	-6.7	-1.3	-1.0	0.3	54.0	9.5	4.8	2.4	0.8	-0.8
Anchor Accelerator	Feb-16	3.5	10.2	4.2	4.0	-2.1	0.1	10.7	-10.9	-5.4	-3.8	2.6	-0.5
OFFSHORE													
High Street Equity - Dollars	Jun-12	10.0	86.5	-10.1	-7.9	-12.2	-7.3	79.4	-8.2	-8.9	-13.3	-7.6	7.0
High Street Equity - Rands	Jun-12	20.0	226.7	4.6	-3.4	-10.8	-3.8	215.2	6.5	-4.8	-12.0	-4.5	11.6
Offshore Balanced - Dollars	Jun-12	8.8	73.2	-6.3	-5.4	-8.6	-4.7	43.3	-5.5	-5.3	-7.7	-3.8	29.9
Offshore Balanced - Rands	Jun-12	18.6	204.2	9.0	-0.7	-7.0	-1.0	151.8	9.7	-1.0	-6.2	-0.4	52.4
Global Dividend - Dollars	Jan-14	6.6	36.7	-8.3	-5.0	-9.5	-6.1	33.4	-8.2	-8.9	-13.3	-7.6	3.3
Global Dividend - Rands	Jan-14	12.3	77.0	6.7	-0.4	-8.0	-2.5	72.5	6.5	-4.8	-12.0	-4.5	4.5
Anchor Sanlam Global Stable Fund - Dollars	May-15	-1.0	-3.6	-2.9	-3.0	-3.9	-2.3	10.1	2.8	1.4	0.7	0.2	-13.7
Anchor Sanlam Global Stable Fund - Rands	May-15	3.7	14.1	12.7	1.4	-2.5	1.0	30.2	19.1	6.0	2.1	3.7	-16.1
Anchor Sanlam Global Equity Fund - Dollars	May-15	2.5	9.2	-12.6	-17.7	-19.9	-8.9	13.4	-8.1	-7.7	-11.5	-5.7	-4.2
Anchor Sanlam Global Equity Fund - Rands	May-15	5.6	21.8	-4.4	-18.9	-23.4	-11.3	26.4	0.5	-9.1	-15.3	-8.2	-4.6

Source: Morningstar and Bloomberg 31 December 2018

*Provisional performance returns

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