The Navigator

Strategy and Asset Allocation Report
2nd Quarter 2019

ANCHOR | NAVIGATING CHANGE

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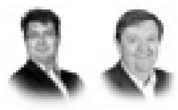
Introduction



Written By:

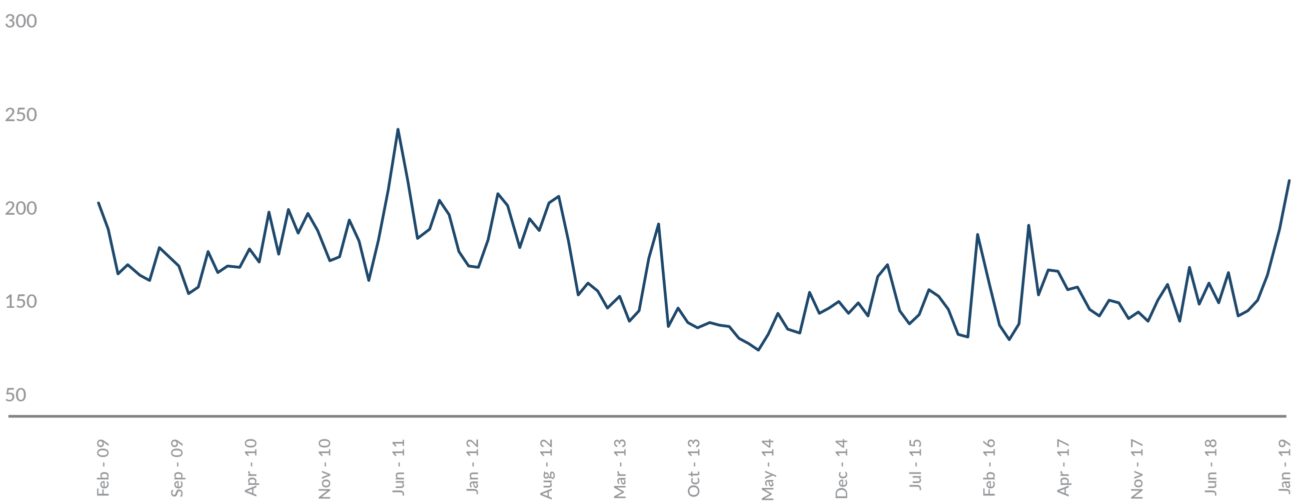
NOLAN WAPENAAR & PETER ARMITAGE
Chief Investment Officers

1Q19 has provided solid investment returns across the board, with the JSE Capped Swix Index returning 3.9% in rand terms and the MSCI World Index returning 12.5% in dollar terms. This, in part, reflects a global market recovery from a downside overshoot late last year. However, on the ground, the economic environment has been difficult both in South Africa (SA) and abroad. Nevertheless, we still see some opportunities in the year ahead and the purpose of this document is to give our clients an insight into Anchor's thoughts on different asset classes as well as our near-term market outlook. We continue to believe that South African fundamentals are improving, albeit gradually. Hence, we find ourselves attracted to the domestic equity market.

In this document the reader will see that uncertainty has been rising. In fact, the Global Economic Policy Uncertainty Index (see Figure 1) has been accelerating sharply, reflecting the rise of nationalism, populism and socialism in response to the inequalities that are prevalent across the globe.

Figure 1: Economic Policy Uncertainty Index

Source: Bloomberg, Anchor



The rising policy uncertainty has had a significant impact on Anchor as the custodians of your wealth. We are good at projecting corporate earnings and understanding the drivers of a business. We also know how to price these businesses for investors and we understand the impact of the economic cycle and the environment on businesses. Unfortunately, however, no one can predict what US President Donald Trump will tweet next, nor what iteration of the Brexit deal will go before the House of Commons next. While we are positive on the outlook for the local general election in May, we cannot be assured of the result. All the above means that we are faced with an increasingly dynamic and fluid environment in which we operate.

The key to successful management of your wealth is an ability to understand the changes to the world in which we live and then to adjust (when necessary) your investment portfolios accordingly.

What looks sensible today, might not seem so tomorrow. The key to successful management of your wealth is an ability to understand the changes to the world in which we live and then to adjust (when necessary) your investment portfolios accordingly. As a boutique asset manager, we are able to navigate these twists and turns of global developments more readily than, for example, a behemoth which is hampered by market liquidity relative to its size. Our team of experienced investment professionals are ideally suited to understand and to react to the rapidly changing environment as we pursue exceptional investment outcomes for our clients.

Our Strategy document focusses on macro themes, asset classes and shorter-term strategy (12 months or less). However, it should not be forgotten that underlying all of this are individual instruments such as bonds and shares. These types of investments are in our DNA and we are always in a pursuit to identify winning companies, which can deliver superior growth over time. Through market ebbs and flows, shares of quality companies can be acquired, creating compounding value for investors. So, our clients with a long-term perspective can relax, secure in the comfort that they have some of the world's best CEOs, working for them every day, in some of the world's best businesses.

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			●	13.0%
Bonds		●		8.1%
Property		●		10.6%
Cash		●		7.3%
GLOBAL				
Equity		●		-3.5%
Government Bonds	●			-8.1%
Corporate Credit	●			-8.0%
Property	●			-8.8%
Cash		●		-7.1%

Strategy and Asset Allocation

GLOBAL BACKDROP

1Q19 was dominated by headlines and events, both abroad and domestically, around slowing global growth, the possibility of a global recession, populist rhetoric from politicians, fears of a SA Moody's downgrade and rolling blackouts courtesy of Eskom. We are therefore relieved that SA avoided a negative ratings outlook from Moody's and we were positively surprised by the extent of dovishness coming out of the South African Reserve Bank's (SARB's) most recent Monetary Policy Committee (MPC) meeting. Eskom continues to be the elephant in the room for any discussion around SA's economic prospects, while sluggish tax collection and vehicle sales remain symptoms of an economy that is stagnating. Overall, it is therefore difficult to get excited about the domestic economic outlook, with the SARB cutting its economic growth forecast to a paltry 1.3% for 2019. Arguably the SARB has been too optimistic and further downward revisions to our economic growth forecasts are certainly possible.

Globally, economic growth expectations have been trending downwards as well. The US Federal Reserve's (Fed's) Federal Open Market Committee (FOMC) surprised at its March meeting when it indicated that it may not hike rates at all this year. This gives some support to bonds, although the slowing economic growth is concerning to us. At the same time, Brexit appears to have spiraled out of control with the UK's House of Commons seemingly out of touch with the reality in which they have placed themselves. We are clearly seeing the uncertainty hurt the economies of both Britain and the European Union (EU). US President Donald Trump's increased nationalist rhetoric is also extremely worrying with threats of closing the border with Mexico together with other unsettling discursive language, whilst on a more positive note it does sound like trade negotiations with China are gaining some traction.

Overall, the world economy has been slowing and is likely to continue to do so for the remainder of 2019.

Overall, the world economy has been slowing and is likely to continue to do so for the remainder of 2019. The debate seems centered around whether or not we will drop into a global recession. Certainly, global bonds seem to be pricing in a reasonable prospect of this occurring. We are, however, more constructive on the environment and we expect that, while the slowdown will continue, in the end growth will bottom out and a new normal could be established with a slow, but steady growth rate for a while yet. This should provide an attractive backdrop for SA if the country has a sensible election outcome in May and we are able to adopt a more pro-growth set of policies.

SOUTH AFRICAN EQUITIES

We continue to have a positive stance on local equities following the 8% return from the JSE All Share index in 1Q19. Our 12-month projected return is 13%, although there are varied scenarios which could play out over the coming months and which we are observing closely. Being nimble is as important as it has ever been.

Investors in the South African market are going through emotional turmoil at present, with local news getting worse, although the global backdrop is proving to be supportive. Hence, sectoral exposure is increasingly important, and these could be materially differentiated over coming months.

From a global perspective, an increasingly benign backdrop has seen world equities bounce sharply in 1Q19. Importantly, Chinese stimulus looks to be taking effect and a resolution to the terms of trade with the US could provide a further boost. This was in part responsible for the 17% increase in the local resources sector (although there were also commodity-specific drivers) during 1Q19 and the c. 19% increase in index-heavyweight Naspers in the quarter under review. This has also seen a marginally stronger rand, which started the year at R14.35/US$1.

So, at this stage it looks like the rest of the world will be good for our stock market. And this in turn is positive for earnings and share prices of over half of the shares on the JSE. But, back home it is a whole lot more complex. There is no doubt that local economic conditions are under increasing pressure and it's not going to get better soon.

Figure 1: The FTSE/JSE All Share Index performance

Source: Bloomberg, Anchor

SA corporates live in uncertain times and this anxiety is encapsulated in an alarming extract from the recent Phumelela earnings results statement: "The difficulties we faced in the 2018 financial year continued, with political turbulence, labour unrest, criminality, a stagnant economy, low business and consumer confidence, increasing unemployment, higher tax, inflationary administered prices, all a daily fact of business life."

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We are concerned about electricity supply in SA and Eskom's woes have already seen GDP growth and corporate earnings forecasts downgraded for the year. This will remain a structural impediment to growth for some time to come as final demand, manufacturing, logistics and confidence levels get negatively impacted. Government has made it clear that load shedding is here to stay for some time. In the words of Public Enterprises Minister Pravin Gordhan: "We are a recovering democratic government and load shedding in the result of that. We'll get it right in the next year or two". Over half of Eskom's plants are over 37 years old.

The lack of electricity has damaged the local psyche, so why would you consider buying SA-related shares? If one contemplates the future, there is tremendous potential for an improvement off a low base in the next two years. And markets price for the future as opposed to the present. Any sign of a sustained improvement in local economic conditions could see a material re-rating of SA equities, in advance of earnings growth (which might take some time to follow).

SA turned the corner with Cyril Ramaphosa being elected as ANC president at the party's elective conference in December 2017. Many positive moves have been made but, not surprisingly, there is strong opposition within a faction of the ANC against moves to curb corruption and revive embattled state-owned enterprises (SOEs). Our base case is for this direction to be sustained and this could see underweight foreign fund managers direct financial flows back into the SA market. However, one needs to watch the balance of power carefully and we would act quickly to pull back from the SA-incorporated shares if we observe strong signs of a reversion to the politics of the past nine years under ex-President Jacob Zuma.

SOUTH AFRICAN EQUITIES

>CONTINUED

From a sectoral perspective our views are as follows:

- Naspers remains at full weight in our portfolios and we back the core Tencent business as a long-term global play. We do not believe the recently announced Amsterdam listing has a material value unlock. In our view, Tencent now looks fairly expensive, so our expectations are a little more muted after a bounce.

- We still like resource shares and plenty of optionality remains in platinum shares (see Figure 2 below). Resource prices are high and face the prospect of a correction but share prices in this sector are pricing-in a decline. In the event of prices being sustained for a reasonable period, we expect resource shares to be driven higher. We like Anglo American, BHP Group and Exxaro.

- The other big rand-hedge counters have their own specific factors, but we are happy to hold some Richemont and British American Tobacco shares at these price levels.

- The large financial services businesses tend to be fairly mature and market share gains are difficult. Hence, these are quite reliant on GDP growth, which will provide very little in the way of tailwinds over the next 12 months. However, banks in particular are proxies for confidence in the future and foreign money will flow into these stocks in the event of future prospects improving. If things do not improve, credit loss ratios will weigh on future prospects.

- Local retail and industrial shares are cheap as a category and have significant gearing to better GDP growth. We like Bidvest and The Foschini Group. We don't like the local food producers.

- We also don't have an appetite for the telecoms industry as the return on incremental capital is low in an industry where companies are forced to continue investing in new technologies and probably spectrum. MTN might well be due for a bounce after a year of bad news.

Figure 2: Impala Platinum share price performance, ZAc

Source: Bloomberg, Anchor

In summary, the future is far from certain and various scenarios are possible. The offshore component of the JSE should provide support and, if our base-case of a positive SA scenario unfolds, this could see a material bounce. However, our bets are measured, and we are managing portfolios with one eye carefully on the risks. The imminent May general election should provide us with some direction.

SOUTH AFRICAN BONDS

The bond market had a strong 1Q19, with the SA All Bond Index returning 3.81%. During the quarter, the SA yield curve bull steepened with the belly of the curve strengthening by just over 41bps while the long-end of the curve strengthened by 20bps. The yield on the R186 ended the quarter at 8.59%, having started the year at 8.95%.

The bond rally was sparked by the drastic shift in the global interest rate landscape as major central banks assumed a more dovish tone on their policy stances. This has largely been influenced by the slowing global growth environment. In particular, we have seen the US yield curve inverting which has validated the slow growth/ late-cycle environment, while other DMs have seen their yield curves entering negative territory yet again.

We expect the low DM yield environment to reignite the search for yield with EMs and SA, in particular, benefiting. However, SA has a number of headwinds which may limit its ability to fully benefit from an EM rally. The most prominent of these headwinds is a negative ratings review by Moody's, which we expect later this year, and the unstable political environment.

We continue to believe that a negative watch from Moody's is likely, with an increasing probability of a downgrade as economic growth remains stagnant and Eskom remains in crisis mode.

We have revised downward the fair yield of bonds for the next 12 months from 8.75% to 8.70%. This is in sympathy with lower global yields (our fair yield on US bonds now stands at 2.65%) and an upward revision on the fair SA credit spread from 2.25% to 2.50%, while the inflation deferential between SA and the US is unchanged at 3.55%. The summation of the US fair yield, the credit spread and the inflation differential (2.65% + 2.50% + 3.55%) gives a fair yield on the SA benchmark bond of 8.70%. This equates to a 12-month return on bonds of 8.1%, comprising of 8.60% interest carry and capital loss of 0.50%.

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In this outlook we have been cautious of the SA political environment and government's ability to tackle the real problems facing our country. To the extent that there are positive developments on this front, significant gains might arise. We remain neutral on domestic bonds, although we see some risks of a positive surprise.

SOUTH AFRICAN LISTED PROPERTY

The SA listed property market has again been a bumpy ride for investors in 1Q19. There was some cause for encouragement as the index returned over 9% in January after the annus horribilis that was 2018. However, February and March saw those gains being eroded again.

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The problem that the sector faces is the same as the SA economy as a whole. The pedestrian and slowing pace of growth has taken away a vital pillar in the property investment thesis. As SA companies report 2018 results the evidence of this is tangible. Growthpoint, the sector heavyweight, did manage to increase dividends by 4.5% YoY and guided towards a similar trend for 2019. However, closer analysis shows that this is derived from the offshore element of the portfolio, development profits locally, and profit on disposals. Smaller and more focused local property companies that are not able to pull these levers have reported income and distributions going backwards, sometimes at rapid rates.

In addition, factors such as trying to salvage Edcon and the part landlords have had to play/ pay in this process, an oversupply of office space, and Brexit effects on those property companies with UK assets, have obviously not helped. One local property company we interviewed said that the way to think about growth prospects in the next year was that in order to lock-in inflation plus contractual escalations, when leases were up for renegotiation, large reductions in base rentals often had to be a bargaining chip. These negative rental reversions could be up to 20%. This means that if 20% of the buildings are renegotiated annually this rental stream would reduce by 4% (20% x 20%). For the 80% of leases that were 'in force', contractual escalations were approximately 7% - so growth of 5.6% at the portfolio level. This means that the growth outlook is very low single-digits, in this instance 1.6% (5.6%-4.0%).

However, we do believe that income and yield will now be a greater part of the total return prospects for the sector going forward. Yields of SA counters – and indeed the JSE listed companies that have property assets offshore – have risen to levels and spreads that have not been seen often and tend not to last indefinitely.

Figure 3 below shows the rise in a blended historical yield comprising Growthpoint and Redefine, SA's two largest property stocks, in equal weightings.

Figure 3: SA 10-year bond yield v 50% Growthpoint 50% Redefine blended yield

Source: Bloomberg, Anchor

In Figure 4 below, this blended yield is then compared to the 10-year bond yield, and the spread is currently nearly 2%, levels last seen around the global financial crisis (GFC), the euro crisis, and "Nenegate."

Figure 4: The spread between Growthpoint, Redefine blended yield and the SA 10-year bond yield

Source: Bloomberg, Anchor

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 extended this out by three months since our last publication. Domestic inflation has been averaging about 4% to 4.5% of late and is likely to average about 5% for this calendar year. In response to SA's more benign inflation outlook, we have adjusted the inflation differential with the rest of the world down to 3.5%. This has lowered our forecast for the rand somewhat.

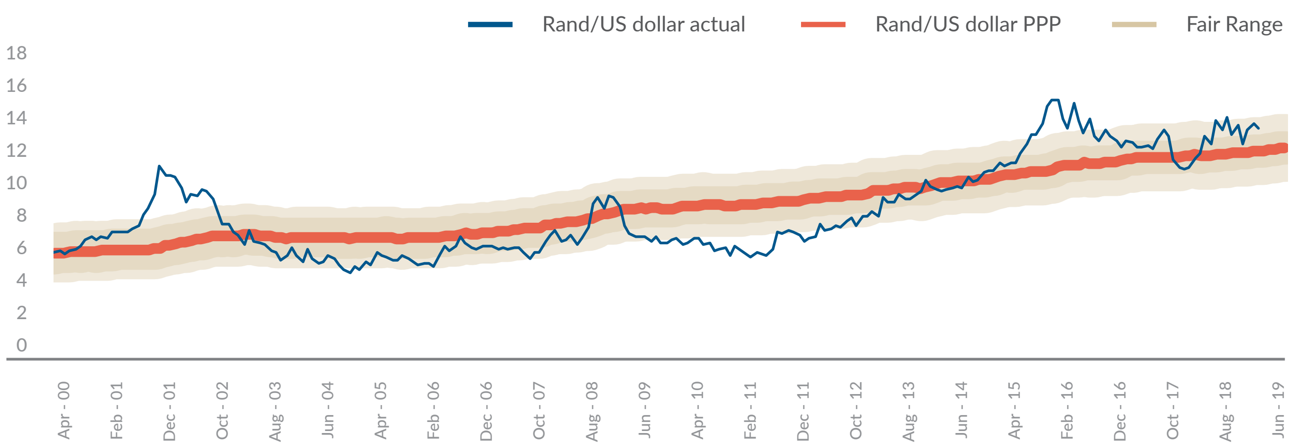
Our PPP-modelled value for the rand vs US dollar at the end of the next 12 months is R13.25/$1. We apply a R2.00 range around this to get a fair value range of R12.25-R14.25/$1.

It is reasonable to expect that, as a more positive EM environment develops (in response to lower global interest yields), we will see the rand move towards the mid-point of the range.

We note that the rand ended 1Q19 at R14.47/$1, which is above our fair-value range. Therefore, whilst we are positive on the prospects of the rand to recover, the movements will remain random depending on both global and domestic events. For modelling purposes, we have used the R13.25/$1 midpoint of our range.

Figure 5: Actual rand/ US dollar exchange rate vs rand PPP model:

Source: Bloomberg



GLOBAL EQUITY MARKETS

We are neutrally disposed towards global equities with a 12-month projected 5% dollar-denominated return. Given our expectation of a stronger rand over the next 12 months, we expect a higher rand return out of domestic equities than global equities. However, our conviction levels for SA equities are not high enough for us to suggest moving equity exposure back to SA for longer-term investors.

A rebound in 1Q19 (S&P 500 up 13%) reversed the decline of 4Q18. World markets are still a few percentage points below their October 2018 highs and 12-month returns are up in the low single-digit range.

Figure 6 and 7 below show the valuation metrics for world markets.

Figure 6: World Index valuations

Source: Bloomberg, Anchor

	Earnings Growth		FWD P/E		
Date	YR 1	YR 2	Current	YR 1	YR 2
MSCI WORLD INDEX	2.3	10.2	15.7	15.3	13.9
MSCI EM INDEX	0.5	13.6	12.6	12.6	11.1
MSCI ALL COUNTRY WORLD INDEX (10% EM)	2.1	10.7	15.3	15.0	13.5

Figure 7: US S&P 500 forward PE multiples

Source: Bloomberg, Anchor

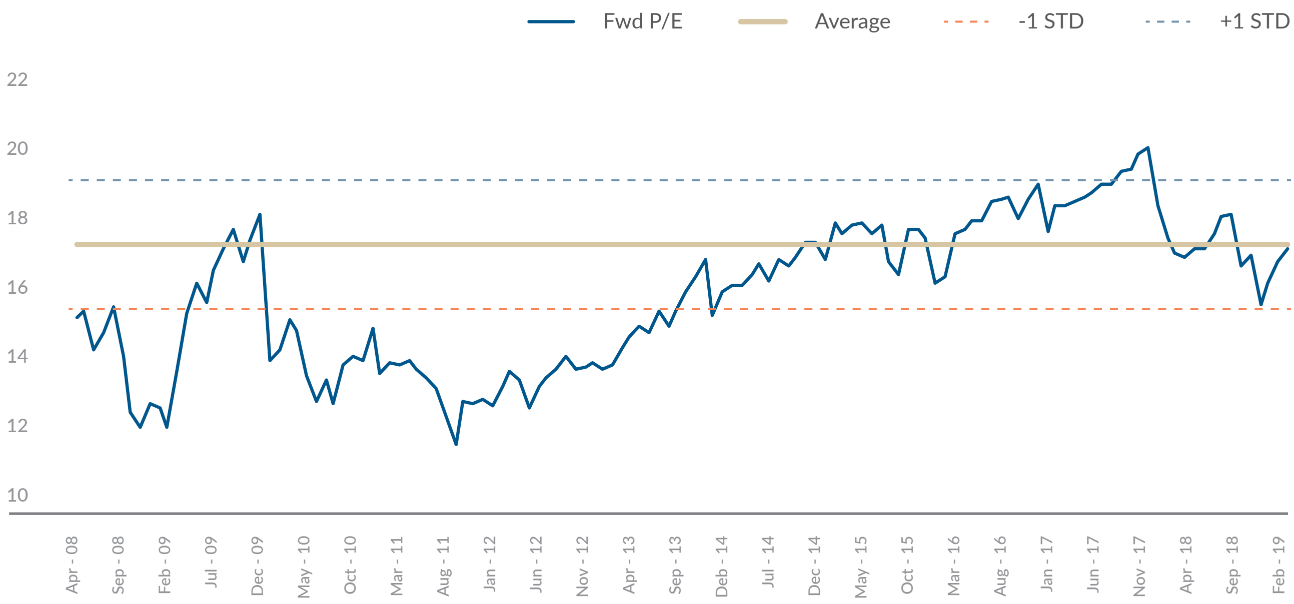
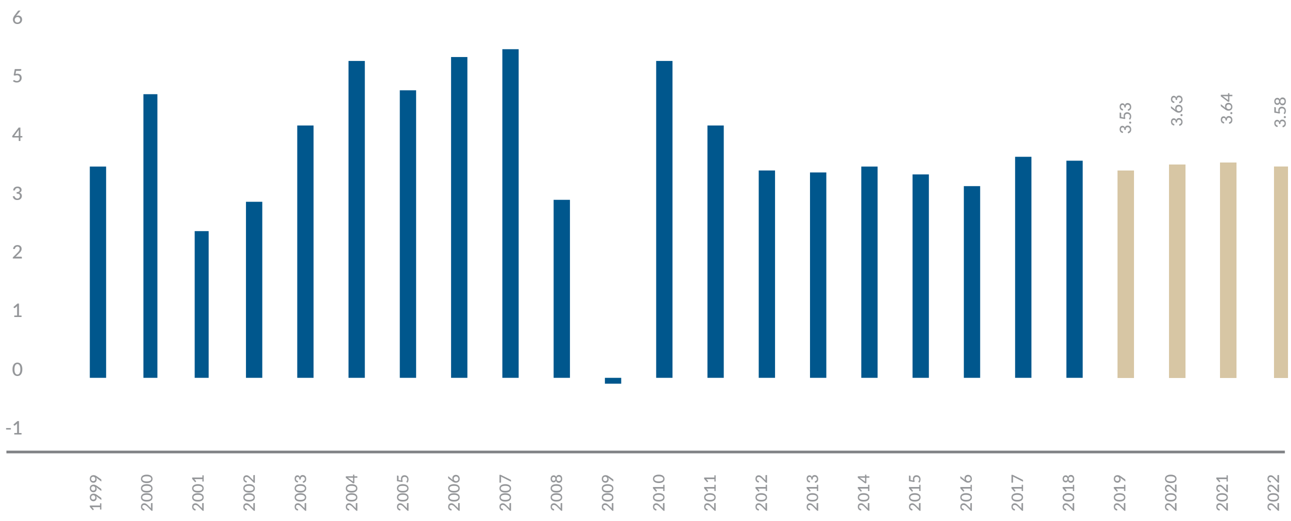


Figure 6 above shows that global equities are moderately priced and in line with 10-year averages (S&P 500 forward PE of 17x). We believe that markets can still deliver reasonable returns from these valuations, but much is dependent on the direction of earnings forecasts. Recent volatility suggests that the market is uncertain as to whether the already lengthy positive global economic cycle can be extended further. This cycle has been unusual in many ways, with the longest period of extremely low interest rates in history and we are currently at a fairly low absolute level of US rates for a pause in the interest rate hiking cycle.

The International Monetary Fund (IMF) is still forecasting very steady world GDP growth for the next few years – of around 3.5% as shown in Figure 8 below. This presumably suggests that the US and other major global players will manage the rate cycle appropriately and there will not be any major disturbances to the world order from factors such as Brexit and the US-China trade spat.

Figure 8: World GDP forecasts

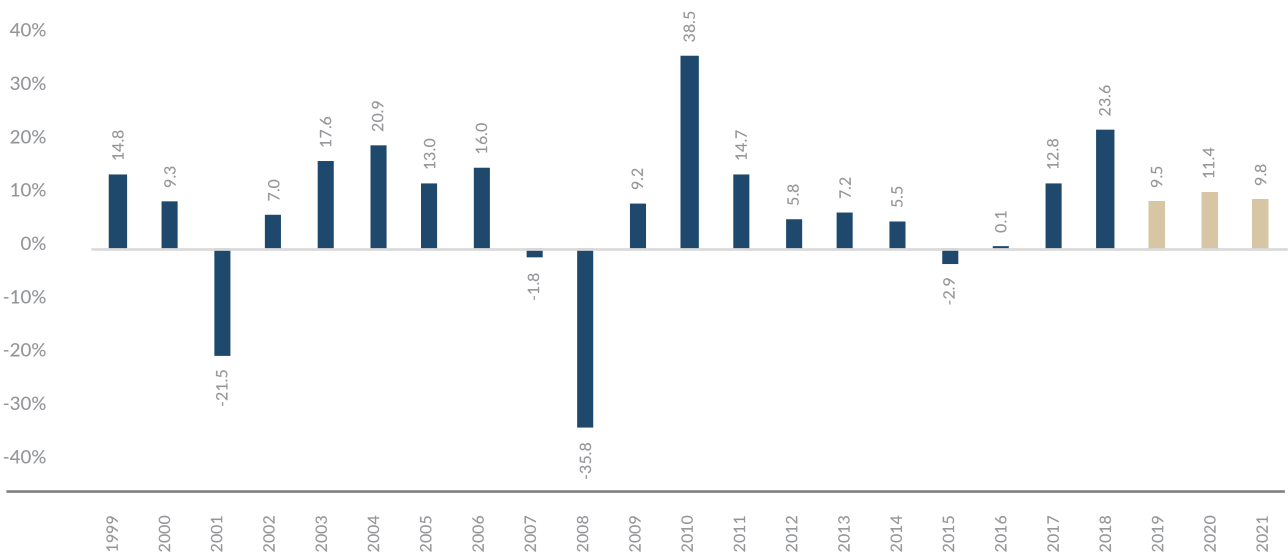
Source: IMF



If global growth remains fairly robust, then US earnings are likely to remain strong and consensus earnings forecasts for the US are in the region of 10% p.a. for the next three years, as shown in Figure 9 below. This is above the 20-year average of 7%-8% p.a.

Figure 9: S&P 500 EPS growth

Source: Bloomberg



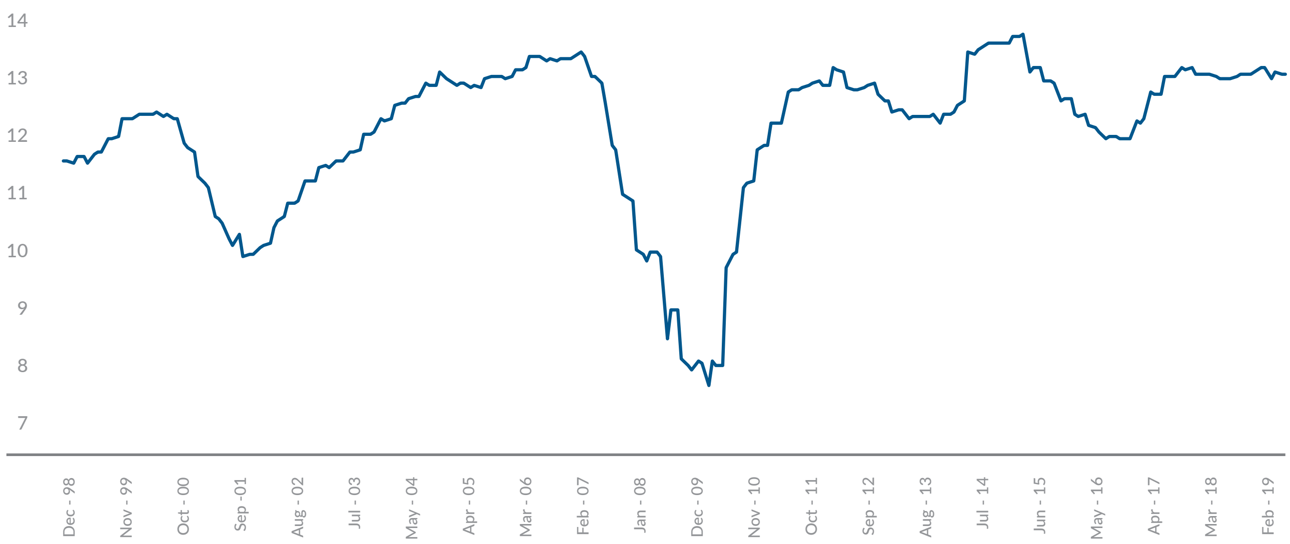
If the earnings growth projected above materialises, then we would expect global stock markets to deliver healthy returns. However, our outlook is a little more conservative as risks have certainly heightened in the last 12 months and the world is at present unusually reliant on the actions of political leaders (Trump, Brexit, Chinese stimulus and oil-producing countries).

It is also worth noting that the average operating margins for companies are close to historic highs (see Figure 10 below).

This suggests that volume/ economic growth is required to drive meaningful earnings and that companies are more vulnerable to a slowdown. However, we do believe margins are sustainable at a structurally higher level given the size and big margins of the major technology companies, which have massive market shares and deliver services at much lower costs (e.g. media through Facebook and Google as opposed to newspapers).

Figure 10: S&P 500 operating margin

Source: Bloomberg, Anchor



The graphs and projections shown above all point to a fairly benign and comfortable outlook. However, this belies the fact that growth projections are being downgraded and growth is being questioned. With German exports showing the worst slump in six years, the ECB pledged more cheap funding for banks and pushed out its expectation for rates hikes from this year to next, also taking a knife to the region's 2019 growth forecast (to 1.1% from 1.7%). The Fed also struck a dovish tone.

In summary, we remain fairly positive and we believe that global economies can continue growing and markets can continue to deliver fair returns, but markets are starting to show late-cycle characteristics.

Within sectors there is likely to be a shift to more defensive sectors given risks to growth and as rates peak, so dividend yields become relatively more attractive. Structurally, we are staying long technology companies as they continue to generate massive cash flows, steal customers away from traditional players, reinvest and create the future and build massive moats around their businesses.

GLOBAL PROPERTY

The year started with global DM REITs delivering their best quarter since 2010 (up over 15%, in aggregate), thanks to the twin tailwinds of a recovering risk appetite and collapsing interest rates which reignited the search for yield. The majority of the 1Q19 performance came from a re-rating of REIT yields by about 0.5%, with almost half of that re-rating coming from the premium investors were willing to pay for income as the search for yield intensified. Our expectation is that, as fear subsides and central banks stave off any chance of an imminent recession in DMs, half of the incremental premium investors have recently been willing to pay for yield will disappear and bond yields will move back towards the levels they were at around the beginning of this year. That should be enough to unwind about 70% of the re-rating we've seen YTD. We think earnings growth should still be around 5% in aggregate and, with an average dividend yield of around 4.1%, that should leave investors in global property with a total return in US dollar terms of -0.4% over the next twelve months.

The re-rating in yields disproportionately favours low-yielding REITs (sectors such as residential, office and industrial), relative to the higher yielders like retail and healthcare REITs and, as such, we expect the de-rating to have the biggest impact on those high-yielding sectors too. Under this scenario, we think that healthcare and retail REITs could deliver positive total returns in US dollar terms over the next twelve months, with the caveat being that retail REITs are still digesting structural changes in shopping habits and oversupply issues, particularly in the UK.

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	12.5	11.4	12.2	4.3	13.0	-	13.0
Global Equity	15.8	1.8	15.8	2.8	5.0	-8.4	3.5
Developed Markets	17.0	2.3	17.1	2.6	5.6	-8.4	-2.8
Emerging Markets	12.6	0.5	12.6	3.0	3.5	-8.4	-4.9

Bonds, Property & Cash	Yield (%)	Capital (%)	LC Return (%)	ZAR (%)	ZAR Return (%)
BONDS					
Local Government Bonds	8.6	-0.5	8.1	-	8.1
Global Government Bonds	2.4	-2.1	0.4	-8.4	-8.1
Global Corporate Credit	2.7	-2.2	0.5	-8.4	-8.0
PROPERTY					
Local Property	9.8	0.8	10.6	-	10.6
Global Property	4.3	-4.7	-0.4	-8.4	-8.8
CASH					
Local	7.3	0.0	7.3	-	7.3
Global	1.3	0.0	1.3	-8.4	-7.1

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 view of the world. This quarter: Nick Dennis asks the question as to what really matters in equity investing; Mike Gresty discusses hedging strategy as a way of mitigating risks; Stephan Engelbrecht makes the case for lower-volatility hedge funds; Matthew Stroucken looks at the power of compounding returns; and lastly, Di Haiden advises on wills, deceased estates and the processes to follow.

ANCHOR INSIGHTS

What really matters in equity investing?

Written by: **NICK DENNIS**
Fund Management

Nick manages the Anchor Global Equity Fund and has been with the business since September 2014. Prior to joining Anchor, Nick was a Senior Investment Manager at Pictet Asset Management, in London.

When unpacking such a big topic it's helpful to start from first principles. In this case, the most fundamental question is: "Why do companies exist?" Otherwise stated, "What is their purpose?" The standard answer for several decades, at least in Anglo-Saxon countries, has been "to maximise shareholder value". More recently, 'stakeholders' have taken precedence over 'shareholders'.

Understanding companies' reason for being leads to the next question: "What makes a good company?" Finally, stepping from the conceptual to the practical, we then ask, "What makes a good stock?" Noting of course the truism that good companies don't always make good stocks!

We compare the metrics of two real companies using data from 2008 to 2018. As you consider the charts below, ask yourself: 1) which was the better **company**; and 2) which was the better **stock**?

Figure 1: Free cash flow ($mn)

Source: Anchor

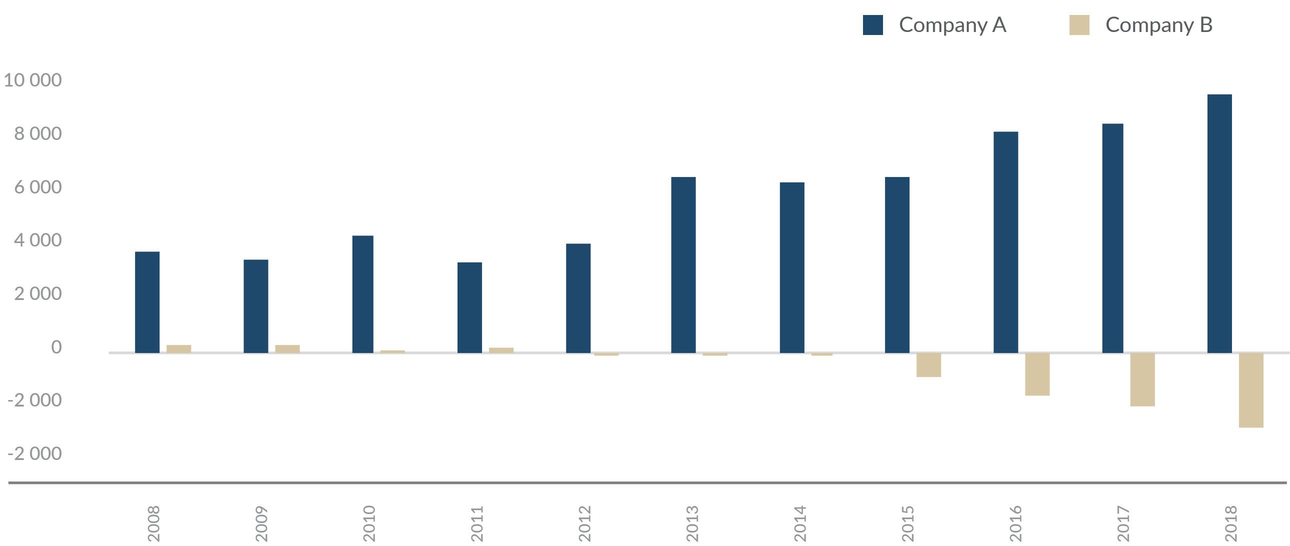


Figure 2: PE Ratios

Source: Anchor

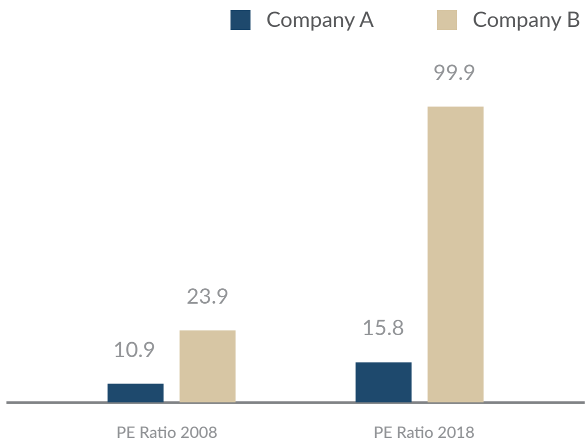
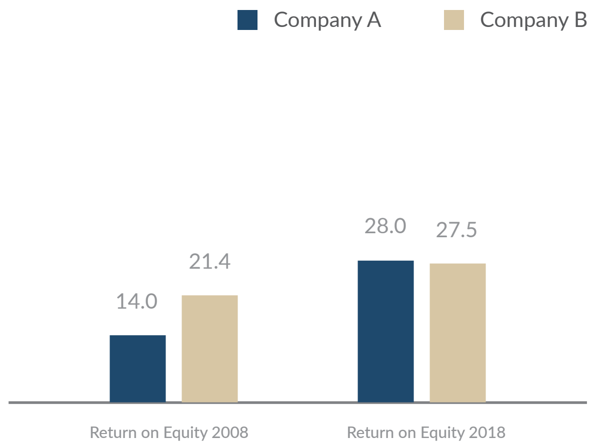


Figure 3: Return on equity

Source: Anchor



It turns out that Company A created substantial value - its market capitalisation increased an impressive $121.2bn over the decade, with the share compounding at 14.5% p.a. (excluding dividends). Company B delivered slightly less value in aggregate, growing its market capitalisation by $115bn. And yet Company B's stock was a massive outperformer, compounding at over 52% p.a.

Company A and Company B are The Walt Disney Co. (Disney) and Netflix, respectively. What is particularly remarkable, is that Netflix's market capitalisation increased from $1.8bn to $117bn over the period. The acorn became an oak tree.

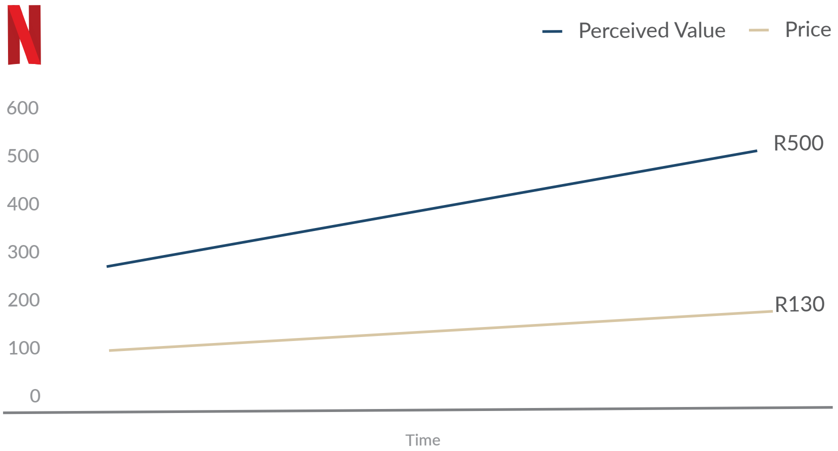
How did this happen?

We believe that Netflix's founder and CEO, Reed Hastings, understands a fundamental truth: **companies exist to deliver value to customers and the best companies deliver more value than they capture**. Netflix's share price has grown rapidly as a **bi-product** of the external value the company has created.

South African subscribers to Netflix currently pay around R130 per month. We suspect that many subscribers perceive the value to be as high as R500 per month. The gap between the perceived value of the service and the price is one way of thinking about the aggregate value Netflix is 'giving away' to consumers.

Figure 4: Netflix offers compelling value to consumers

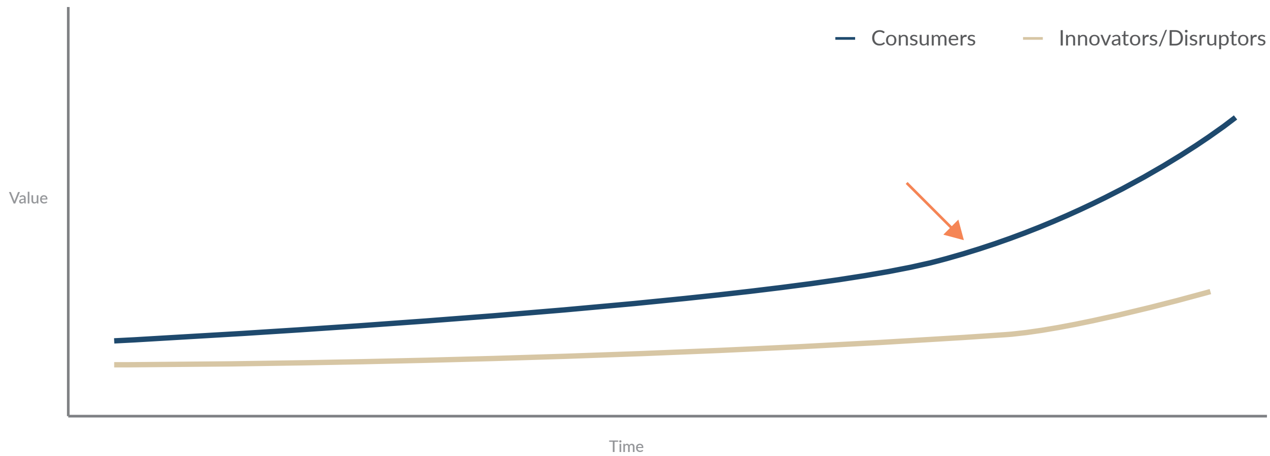
Source: Anchor



Netflix is used to illustrate a broader point. Other major innovators and disruptors (Amazon, Alibaba, Google etc.) have operated on the same principle over the past decade. The red arrow in Figure 5 denotes the impact of the internet, which facilitated the delivery of value to consumers on an unprecedented scale.

Figure 5: Internet disruptors have generated substantial value for consumers and shareholders

Source: Anchor



By contrast, many legacy brand owners have rested on their laurels for too long and no longer offer consumers a compelling value proposition. This dynamic has been most prevalent in the Fast-Moving Consumer Goods space, where Kraft Heinz recently fell an astonishing 27% in a single day after writing off over $15bn in goodwill relating to its Kraft and Oscar Mayer brands. Kraft Heinz has shed roughly $60bn in market capitalisation in the past 18 months – a stunning fall from grace for what was previously considered a high-quality, defensive business.

The Kraft Heinz episode reveals the flaws in the "shareholder value maximisation" ideology. While the '3G Model' of slashing costs to boost margins and shareholder returns enjoyed initial success, it has ultimately resulted in long-term value destruction.

The term 'moat' has been used to describe a firm's source of competitive advantage. Many legacy brands no longer qualify as moats, possessing neither the ability to drive purchasing decisions nor pricing power. This does not discredit the moat as a conceptual model. **The core principles remain unchanged, but the manifestations and applications thereof constantly evolve**.

The Disney-Netflix comparison provides an important insight into the relationship between moats and share price performance. **The absolute size of the moat is less important than the direction in which it is moving**. It is hard to argue against Disney being a better company over the past decade, given its prodigious cash flows and attractive returns on capital. However, while Disney has been a partial casualty of the fraying cable bundle, Netflix has rapidly built an impressive moat in video streaming.

The direction of Disney and Netflix's moats over the next decade is a source of intense debate and analysis within Anchor (Disclosure: we hold both shares on behalf of clients in different mandates). Based on the framework we've established above, it stands to reason that **the company that delivers the greatest aggregate consumer value will build the deepest moat and generate the highest market returns**.

In the short term, none of this matters. The share prices of Disney and Netflix are hostage to the latest newsflow on trade wars, Trump, Brexit, interest rates ... the list is endless. It is only in the fullness of time – often a decade or more – in which their steady efforts translate into outsized returns. Only by gaining a deep fundamental understanding of the "Why" and the "How" – why companies exist and how they deliver value – are we able to endure the vicissitudes of the market and participate in their long-term returns. This is what **really** matters in equity investing.

ANCHOR INSIGHTS

Thinking about hedging?

Written by: MIKE GRESTY
Fund Management: Robert Cowen Investments

Mike is a fund manager of Robert Cowen Investments, a subsidiary of Anchor, and has been with RCI since June 2018. Prior to that, Mike held a variety of equity research roles at Citigroup and Deutsche Bank.

Reflecting on the South African equity market's performance over the last few years, one rather unsettling observation has been the unusually large number of blue-chip companies that have recorded dramatic price declines over a short space of time.

Steinhoff and Aspen, which suffered share price declines of 89% and 35%, respectively, over a few days, spring to mind. However, there were others too: Mediclinic, EOH etc.

Figure 1: Steinhoff share price (ZAc)

Source: Bloomberg

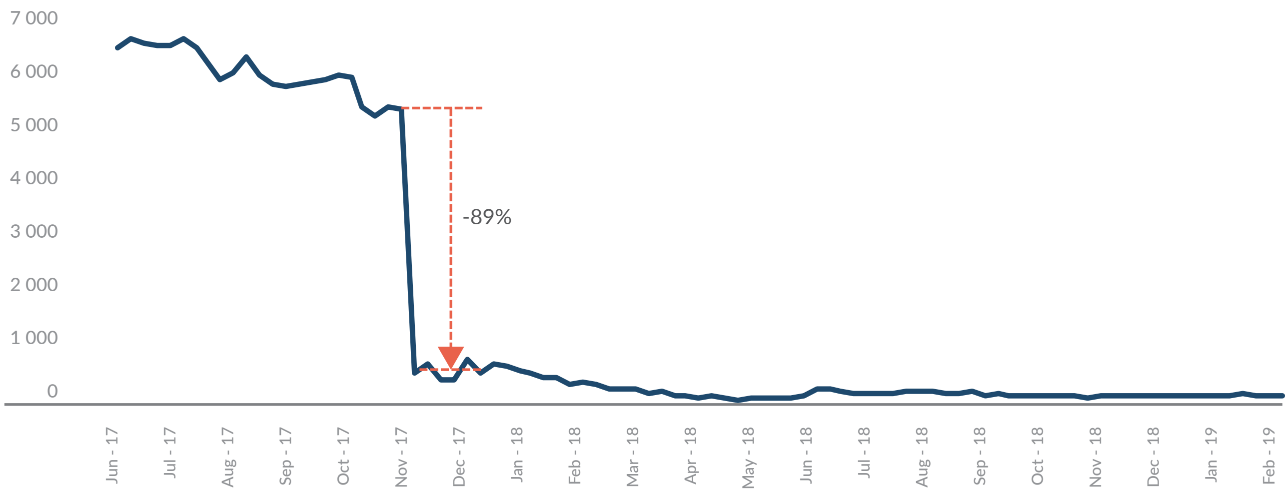
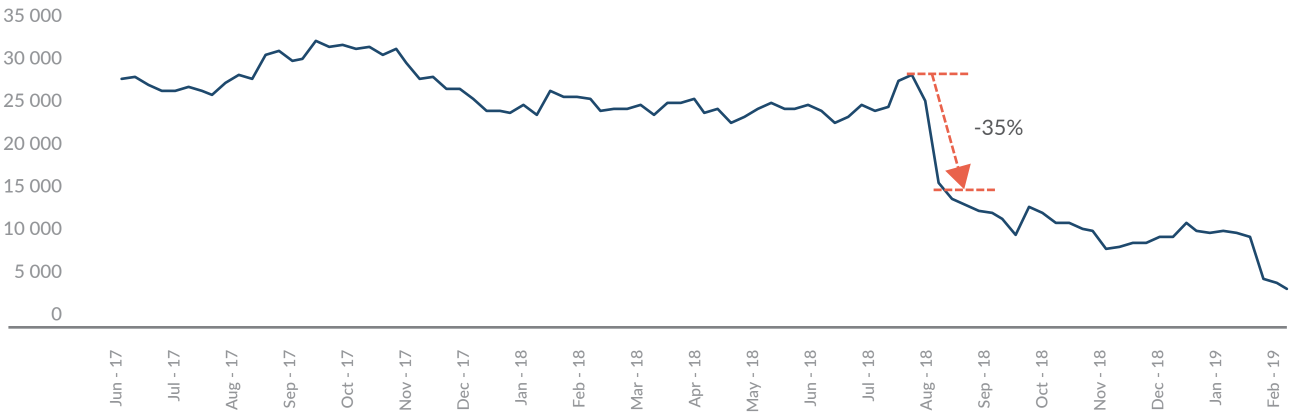


Figure 2: Aspen share price (ZAc)

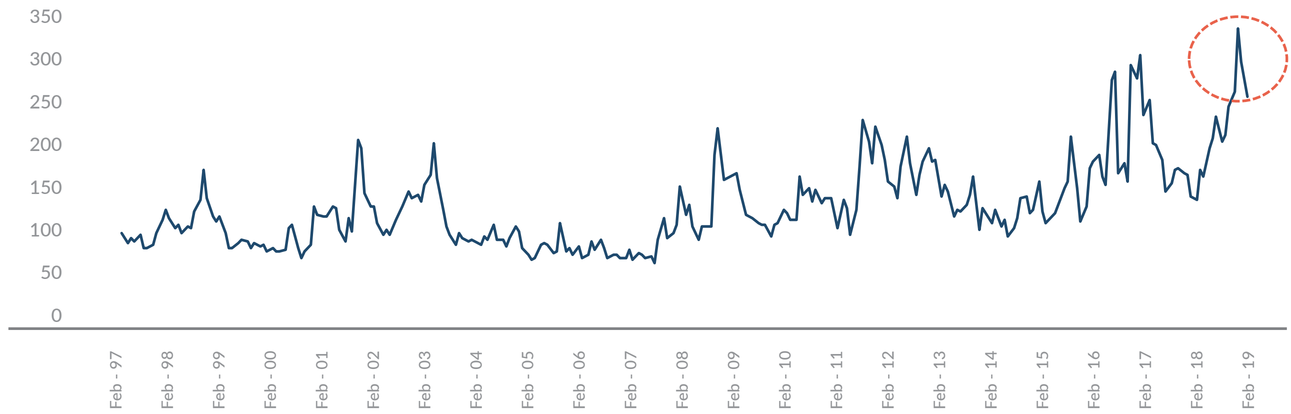
Source: Bloomberg



The reasons for these precipitous falls varied, but there was one constant – the damage these companies did to their investors' wealth. Given one's inability to predict these types of events ahead of time, as well as the tax consequences which accompany trading, are there ways to mitigate such risks? Indeed, with global economic uncertainty at the highest levels in 20 years, it would seem an opportune time to take a practical look at some protection strategies available to an investor.

Figure 3: Global Economic Policy Uncertainty Index

Source: Baker, Bloom & Davis



Before identifying some of the specific derivative strategies that could be employed, we summarise certain broad principles to keep in mind. The concept of hedging should be compared to insurance. Typically, you wouldn't insure your car only when you thought you were most likely to have an accident - the timing of accidents is unpredictable (as is the timing of market corrections). So, if you're unwilling/ unable to accept the risk of being personally liable for the cost of car repairs if/ when accidents happen, then you need to accept the ongoing cost of car insurance, which will ultimately result in you paying more than you will claim over the long term.

Options, much like car insurance, are priced in a way that the underwriters are generally going to make money over time (and as such the purchasers/ hedgers are going to lose money over time – in option lingo, realised volatility is always lower than implied volatility through time).

Similarly, with investment hedging, you need to accept that the chances of you being able to time when you need portfolio insurance/ hedges are pretty slim and, as such, **you will need to decide whether you are willing to accept that you will incur occasional market losses and, if not, then you will need to accept a lower long-term return in order to mitigate against occasional losses. This can be done** either by having a **more conservative asset allocation** (i.e. less of your portfolio exposed to large potential losses) or **by having a permanent hedging strategy in place**. As an aside, **when people are most worried about market losses, the cost of insuring against those losses is the highest**.

INDEX AND SINGLE-STOCK FUTURES CONTRACTS

***Strategy*:** Sell FTSE/ JSE Top-40 Index futures contracts up to the value of the local portfolio. The way these futures work is as follows:

The price of a FTSE/ JSE Top-40 Index future is R10 per index point. Thus, at a Top-40 index level of 49,000, each future would give an investor R490,000 (49,000 x R10) of market exposure.

One is required to post a margin in cash. This varies but, on index futures, it is 8%-10% as a rule of thumb.

Pros

This is a relatively cheap way in which to hedge. Brokerage on futures contracts is low (around R10 per contract).

Since the hedge requires you to sell a futures contract, you are 'short' the future. One earns interest (adjusted for expected dividends) over the period.

Cons

It is likely the weighting of shares in the portfolio will not match the index. Therefore, the hedge is an imperfect one. A material move in the price of a share, which has a weight in the portfolio that is very different to that stock's weight in the index, will mean the hedge proves ineffective.

Should the market rise, this will result in a loss on the futures position. This will mean the benefit of a rising market is largely foregone.

The requirement to post margin, would require the portfolio to hold a cash position that may be higher than it would otherwise choose to hold.

As a possible alternative to index futures, it is viable to use single-stock futures to hedge individual stock positions in the portfolio. This could give a more accurate hedge. However, the margin requirement on single-stock futures is higher for a share that is in the top-60 on the JSE in terms of market capitalisation, the margin can be 10%-15%, depending on the volatility and liquidity of the share (the margin rises for smaller shares if single-stock futures are available at all).

INDEX OR SINGLE-STOCK OPTIONS?

***Strategy*: Buy a put option on the FTSE JSE Top-40 Index.** In return for the payment of a premium, the buyer of a put option profits if the index falls below the strike price. The size of the premium paid is mainly a function of (1) the strike price relative to the current index level (the further below the current index level the strike price is, the cheaper the option); (2) volatility (the more volatile the index is the higher the premium); and (3) time (the longer the option term, the higher the premium).

Pros

Outside of the premium paid, you do not forgo all upside should the market rally.

Cons

The premium represents a hard cost, which will be a drag on the portfolio performance in those instances where the market rallies or does not fall sufficiently for the option to be in the money (in the case of the purchase of an out of the money put).

As with index futures, the fact that the underlying portfolio does not match the index means that this is an imperfect hedge. As with futures, though, a more accurate hedge could be achieved by using single-stock options.

Options have a finite life and, on expiry, must be renewed with the payment of a further premium. If one assumes that markets rise over the long term, it is likely that the cost of maintaining a perpetual hedge against losses would more than erode returns.

Unlike a dynamic stop-loss, which one can adjust upwards as the market rises, the fixed strike price of an option means that, if the market rallies, what started out as an at-the-money hedge becomes increasingly out of the money. This means that subsequent market pullbacks are not hedged, unless the fall is to a level below the strike.

Currently, the premium payable on a put option that expires in 4 months' time and has a strike at the current level of the index (an at-the-money option) is about 4%. This premium will differ at each point a new option is purchased, depending on the market conditions at the time, but this implies a cost of roughly 12% for full-year downside protection. There are ways to bring down this cost, which essentially involves the investor accepting some level of downside risk or being prepared to forego upside beyond a certain level. This is achieved either by purchasing an out-of-the-money put, or by purchasing an option structure (comprised of several different options that, when combined, provide a different payoff profile).

The technicalities of option structures are beyond the scope of this article, but to give a few examples of option structures that bring the cost of hedging down by the investor taking on more of the risk, we highlight the following:

A "collar" – the investor gets protection should the index/ stock decline in value, but also foregoes the upside beyond a certain level should the index/ stock rise over the term of the structure.

A "bear spread" – the investor is protected from a decline in the index/ stock, but only to a certain level, beyond which the investor carries the risk of further downside.

TAX CONSIDERATIONS

There is no specific derivative tax legislation in SA that applies to the equity derivatives discussed above. Furthermore, there is no specific case law dealing with the tax treatment of derivative transactions like this either. As a result, the ordinary principles of South African tax law will apply to payments made or received.

Derivative positions are generally entered to serve one of the following purposes: (i) for speculative reasons, as part of a profit-making scheme; (ii) with the intention of earning a return – i.e. as a capital investment; or (iii) to hedge an underlying asset/ obligation, which may be a revenue or a capital asset.

In this instance, the use of an equity derivative (single-stock or index futures and options) is to hedge shares which are held as capital assets (or deemed a capital treatment because of the three-year, safe-haven rules). Although there is no case law precedent in this regard, it appears to be generally accepted that, where a derivative transaction is entered into with the purpose of hedging the value of a capital asset, any amount derived from that transaction should be of a capital nature.

To the extent possible, there should be a match between the nature, extent and duration of the derivative and the nature, extent and duration of the risk (equity) which is being hedged. If the equity derivative is not a perfect hedge but has a sufficiently close link to the underlying equities, it should follow the capital nature of the underlying. However, there can be many commercial (non-tax) reasons as to why a perfect hedge cannot be obtained, so as long as there is a link to the underlying, which can be demonstrated, the equity derivative can be treated as capital.

With considered risk sharing, the cost of these hedging solutions can be significantly reduced.

The disposal of equities that have been held for less than three years, and the fact that the South African Revenue Service (SARS) is able to apply discretion based on the pattern of trading activity, creates the risk that these transactions are deemed to be of a 'trading' nature and are taxed as such. So, would the use of derivatives for hedging purposes influence the decision made by SARS in these instances? Provided the intention for acquiring the equities (despite not being held for three years or longer) is to earn returns on the equity, an equity derivative concluded to hedge its risk should not taint the capital nature of the equities.

IN CONCLUSION THEN…

For investors who have a truly long-term investment horizon and can resist panicking in market downturns, trusting that the broadly rising tide of equity markets over time will consign these declines to barely discernable blips on the chart, the costs of hedging appear prohibitive to maintain on a perpetual basis. However, there may be many specific situations where considering some protection makes sense – a near-term need for cash or a particularly large position in an individual stock about to report results, for example. In these cases, there are solutions out there which may be worth considering. Furthermore, with considered risk sharing, the cost of these hedging solutions can be significantly reduced.

ANCHOR INSIGHTS

When chance is not on your side, volatility matters

A case for lower-volatility hedge funds

Written by: STEPHÁN ENGELBRECHT
Fund Management

Stephán is part of the investment team at Anchor with a special focus on alternative investment solutions. He manages long/short equity hedge funds. He joined Capricorn Fund Managers in 2010 before joining Anchor earlier this year.

A sure way to get me excited is to give me a good novel to read - if the author happens to be Jeffrey Archer then so much broader the smile. Recently, I read his latest, *Heads You Win* and, as with all his books, the premise is very thought provoking. The protagonist has to flee Russia by making an instant decision on which of two ships to board - one heading to the UK or the other going to the US. To decide the protagonist flips a coin and the story follows his life in two alternate realities, highlighting how great an impact that one moment of chance had on his life.

By now you might be wondering why there is a book review in the Anchor Strategy report. Well, there is indeed method to the madness. The book started me thinking about how frequently chance impacts our lives and, more relevant to this discussion, how often it impacts our financial wealth.

There are many fronts where chance has a significant impact on financial markets, but in this piece, I would like to focus on time. By time I mean the random chance that affects all of us i.e. when we start saving and when we need to withdraw our savings. I will investigate how significantly this random piece of luck affects the savings amount of many investors. I will also highlight how available investment information often neglects to accentuate how severely an investor will be impacted by these chance events and why investors must pay much closer attention to the volatility of a product's returns.

THE PROBLEM WITH PERFORMANCE DATA

I am a statistician. Numbers get me excited as they allow you to do many wonderful things, but numbers are also dangerous. When numbers are used incorrectly and not considered in the right context, the solutions offered by these numbers can be misleading and cause great harm. Quite often those providing the numbers and solutions are not intending to mislead, in fact they might provide all the information an investor will require, but by focussing on the wrong information investors, and their advisors, may come to an erroneous conclusion.

A key performance metric that can lead to some very dangerous allocation decisions is the return metrics of a fund. Often, fund factsheets highlight the performance of a fund over various periods, usually one-year, three-years, five-years and since inception. These returns are important in evaluating whether a fund manager is worth his/her salt but, taken out of context, they are also very dangerous.

To highlight my point, I will focus on two specific investment options available. The one being the FTSE/JSE All Share Index (ALSI) and the other the Capricorn SCI Stable Hedge Fund (Stable Fund). The Stable Fund launched in June 2003 with its mandate being to provide investors with a return between that of bonds and equities but at a volatility lower than that of bonds. The fund has a keen focus on preserving capital and has been very successful in achieving its objectives, with only 2016 being a blip on a history of constant performance and capital preservation.

However, when looking at the performance data, this fund may not attract the eye of an investor. Compared to the ALSI, the Stable Fund has a lower compound annual growth rate since its inception. And, if you consider the compounding effect of the superior return on the market, then a long-term investor will argue that the ALSI was the better investment option.

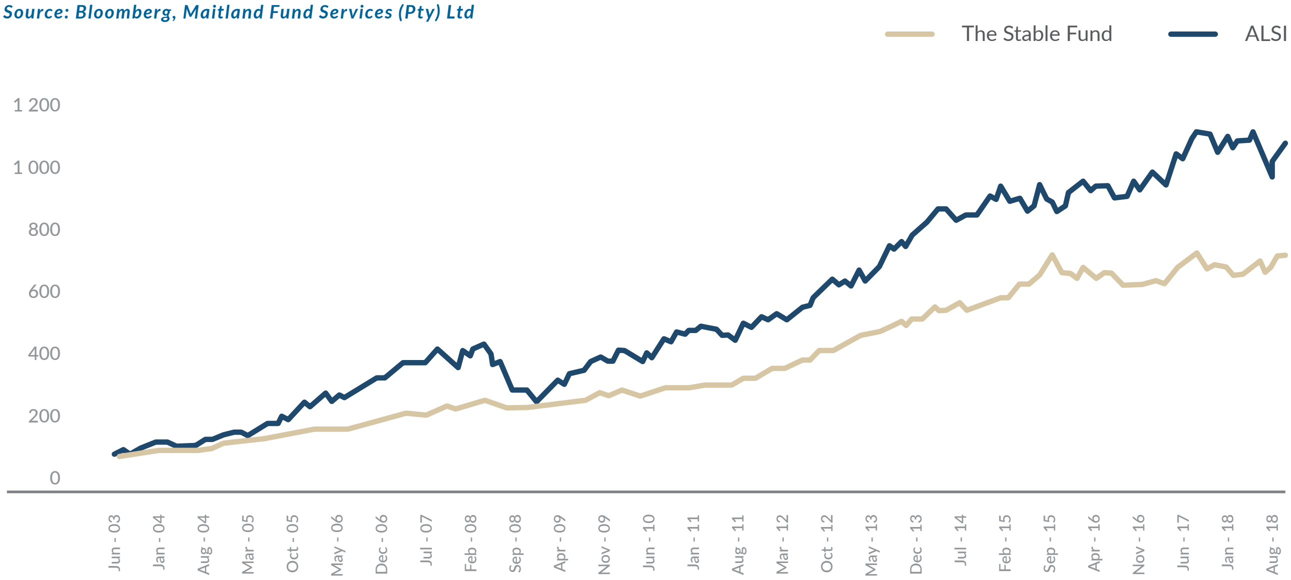
Figure 1: Performance summary of the Stable Fund and the ALSI since inception (June 2003)

Source: Bloomberg, Maitland Fund Services (Pty) Ltd

	The Stable Fund	ALSI
CAGR	12.8%	16.2%
VOLATILITY	6.8%	14.8%

Figure 2: Performance of the Stable Fund and the ALSI since inception (June 2003)

Source: Bloomberg, Maitland Fund Services (Pty) Ltd



However, Figure 2 is a very misleading to the investor experience. The only investor that will be lucky enough to experience this compounding performance will be the person who invested a lump sum on 30 June 2003 and never invested or withdrew another rand from their investment since. The odds of being that investor is tiny. And the odds of experiencing a similar investment performance are even smaller.

The key statistic which we have ignored in our assumption, that the ALSI was a better investment than the Stable Fund, is the volatility of the two options. The Stable Fund has generated its return with less than half the volatility of the ALSI. Does this matter? Yes, especially if you, like many other investors, contribute monthly towards your investment portfolio.

MEET NELSON AND JONATHAN

So, let's consider two 'normal' investors, Nelson and Jonathan. Nelson was born in 1978. By the age of 25 (2003), Nelson got his first well-paying job and, being a very diligent individual, he started saving R1,000/month in June 2003, increasing his monthly contribution by 6% in January of each year.

Nelson's investment portfolio had two key contributors to the overall value of the performance - his monthly contribution and the performance of his selected fund. Initially, Nelson's monthly contribution was by far the greater contributor to the value of the portfolio but, over time, as his portfolio value grew the performance of the selected fund becomes more important. Figure 3 provides an example of how the portfolio value will change over time.

Figure 3: Nelson's portfolio value when investing in the Stable Fund

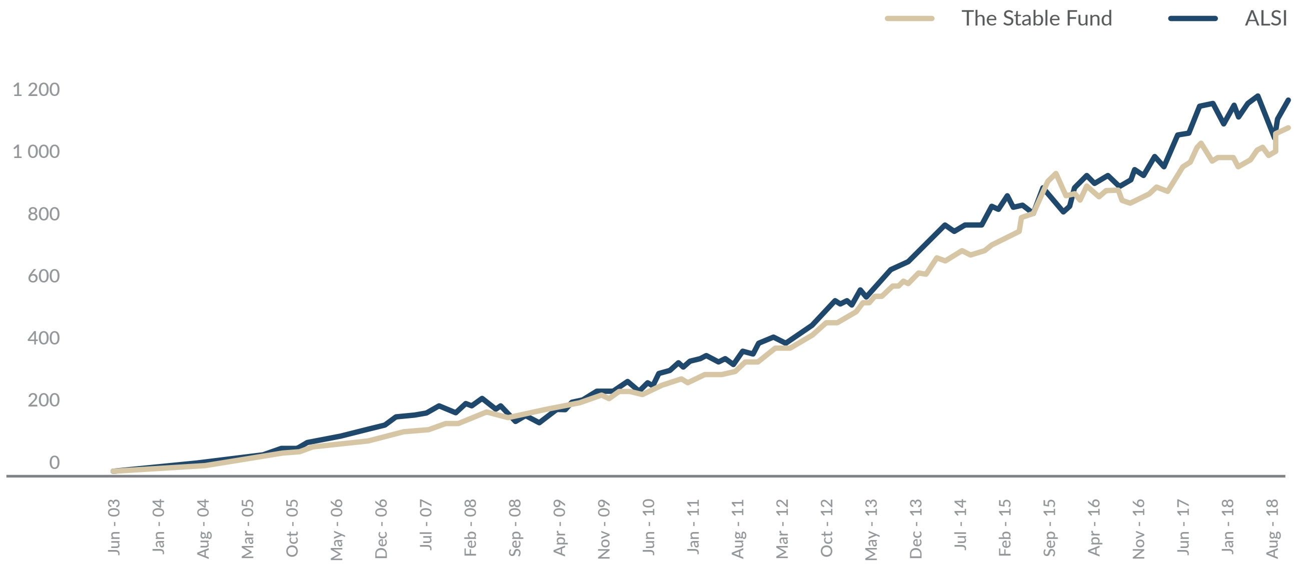
Source: Maitland Fund Services (Pty) Ltd

Date	Opening balance (Rand)	Stable fund return	Performance contribution, (Rand)	Monthly contribution, (Rand)	Closing balance, rand
JUN 2003	0.00	0	0.00	1,000.00	1,000.00
JUL 2003	1,000.00	0.90%	9.00	1,000.00	2009.00
AUG 2003	2,009.00	0.70%	14.10	1,000.00	3,023.10
SEP 2003	3,023.10	0.50%	15.10	1,000.00	4,038.20
...	...	...	...	...	...
NOV 2007	95,464.80	1.70%	1,622.90	1,262.50	98,350.20
DEC 2007	98,350.20	1.50%	1,475.30	1,262.50	101,087.90
JAN 2008	101,087.90	-2.80%	-2,830.50	1,338.20	99,595.70
FEB 2008	99,595.70	4.30%	4,282.60	1,338.20	105,216.50

Nelson's portfolio value is very different to Figure 1. We can see that for Nelson the low volatility of the Stable Fund meant that every contribution he made compounded at a similar rate, causing the Stable Fund to only slightly underperform the ALSI.

Figure 4: Nelson's investment portfolio value over time

Source: Bloomberg, Maitland Fund Services (Pty) Ltd



Next let's consider Jonathan. Jonathan was born four years later in 1982. He was also appointed to his first well-playing job at the age of 25 and started saving R1,000/month in June 2007, increasing his contribution by 6% in January of each year. Nelson and Jonathan are investing in the same prudent manner; the only difference being that Nelson is four years older than Jonathan and could thus start saving four years earlier.

Jonathan was unfortunate (or perhaps fortunate) to start investing at the back-end of a bull market. The performances of the funds were thus markedly lower than that experienced by Nelson, with the return statistics as follow:

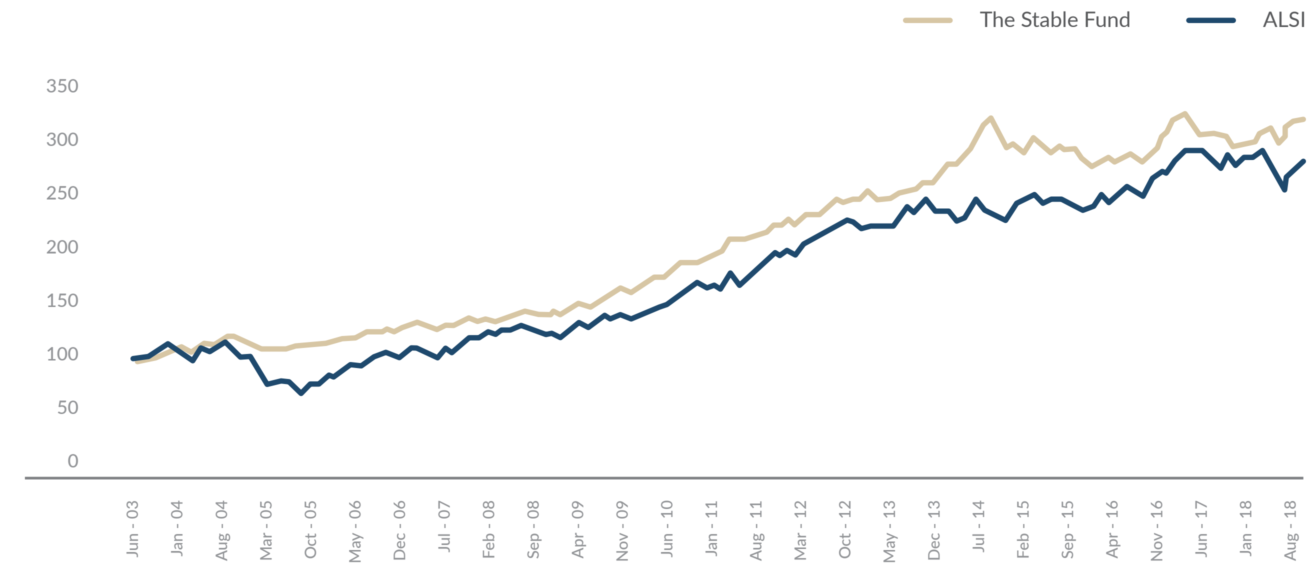
Figure 5: Performance summary of the Stable Fund and the ALSI since June 2007

Source: Bloomberg, Maitland Fund Services (Pty) Ltd

	The Stable Fund	ALSI
CAGR	10.1%	9.9%
VOLATILITY	7.2%	14.7%

Figure 6: Performance summary of the Stable Fund and the ALSI since June 2007

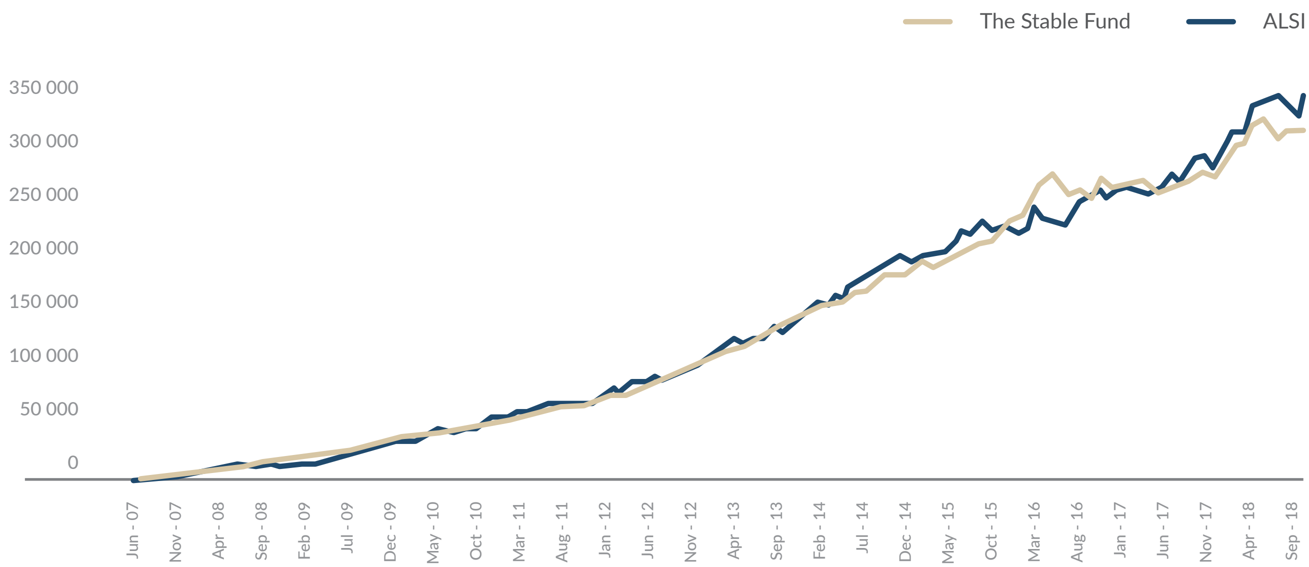
Source: Bloomberg, Maitland Fund Services (Pty) Ltd



Ironically, Jonathan did not suffer that greatly from the 2009 bear market. At that stage of his investment journey, his monthly investments contributed much more to his portfolio than the performance of the market. His investment experience would thus have been very similar regardless of whether he invested in the ALSI or the Stable Fund.

Figure 7: Jonathan's investment portfolio value over time

Source: Bloomberg, Maitland Fund Services (Pty) Ltd



WHEN THE RAINY DAY ARRIVES

But again, I believe that we have missed the crux of why people invest. Prudent investors will have a long-term objective and attempt to match the return profile of their investment portfolio to the return required to achieve their objective. It is thus important to measure the success of an investment portfolio relative to where the investor would expect his/her portfolio value to be at that point in time.

Let's assume that Nelson and Jonathan both acquired the services of the same investment advisor, John. John has a very consistent view of the world and believes that the expected returns of the various investment options will remain the same over time, especially when considering that you are a long-term investor (*we can debate this view in more detail in a later strategy document*).

John believed in 2003 and in 2007, respectively, that investors in the ALSI can expect a 14% return (inflation +8%) and investors in the Stable Fund can expect an 11% return (inflation +5%). Nelson and Jonathan thus had a reasonable expectation of where their investment portfolio should be at any point in time.

This is where the very real impact of 'Lady Luck' comes to the fore. Nobody can predict when their rainy day will arrive and thus a key measurement of an investment portfolio is how much it is deviating from your expectation. And this is where the volatility of a fund can cause some real havoc with the financial wellbeing of an investor.

Let us first consider Nelson's reality vs his expectations. Nelson was very fortunate to start his investment journey at the beginning of a strong bull market. For the first five years of his investment journey his portfolio outperformed his expectation considerably, especially if he invested in the ALSI. It is after the GFC in 2008 that the picture started to change and by the end of 2018 his portfolio value was 26% below what he would have expected. If Nelson was unfortunate enough that he had to withdraw his investment at the beginning of December 2018, he would have been 26% short of his desired outcome, which he would have had to top up from somewhere, or he would have had to reduce his benefits. Had Nelson invested in the Stable Fund his portfolio value would have been, at worst, 7.24% below his expectation. This is a much more palatable situation.

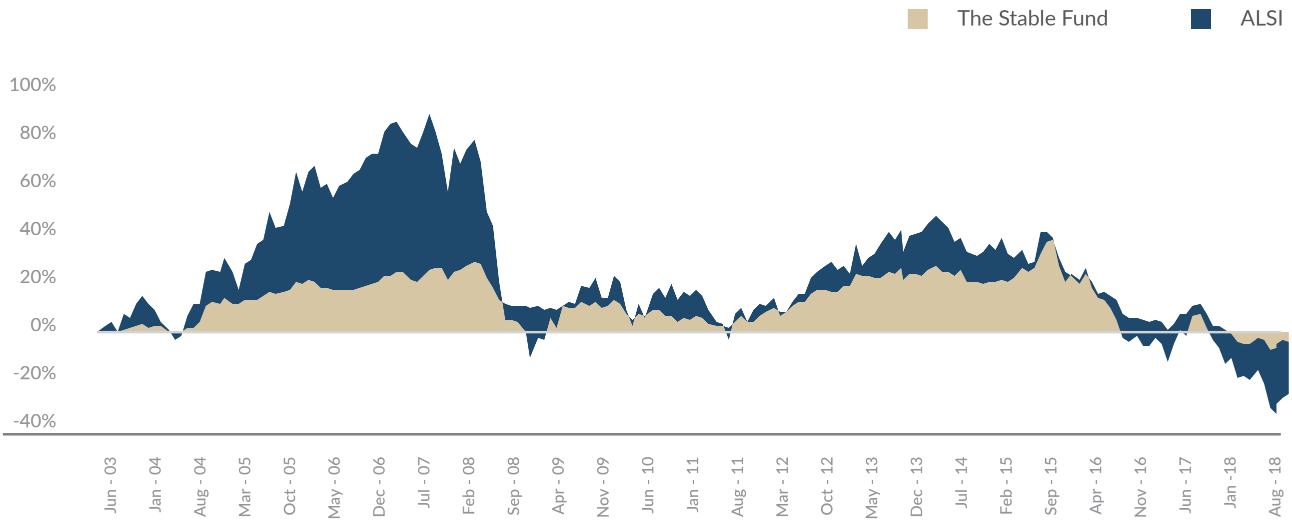
Figure 8: Nelson's portfolio value when investing in the Stable Fund

Source: Maitland Fund Services (Pty) Ltd

Date	Expected opening balance, rand	Expected Stable Fund return (11% ÷ 12)	Expected performance contribution, rand	Monthly contribution, rand	Expected closing balance, rand	Actual closing balance, rand	Deviation from expectation
JUN 2003	0.00	0.00%	0.00	1,000.00	1,000.00	1,000.00	0.00%
JUL 2003	1,000.00	0.92%	9.20	1,000.00	2,009.20	2,009.00	-0.01%
AUG 2003	2,009.00	0.92%	18.40	1,000.00	3,027.60	3,023.10	-0.15%
SEP 2003	3,027.60	0.92%	27.80	1,000.00	4,055.30	4,038.20	-0.42%
...	...	...	...	...	...	...	...
NOV 2007	76,165.10	0.92%	698.20	1,262.50	78,125.80	98,350.20	25.89%
DEC 2007	78,125.80	0.92%	716.20	1,262.50	80,104.40	101,087.90	26.20%
JAN 2008	80,104.40	0.92%	734.30	1,338.20	82,176.90	99,595.70	21.20%
FEB 2008	82,176.90	0.92%	753.30	1,338.20	84,268.40	105,216.50	24.86%

Figure 9: Nelson's investment portfolio value relative to expectations

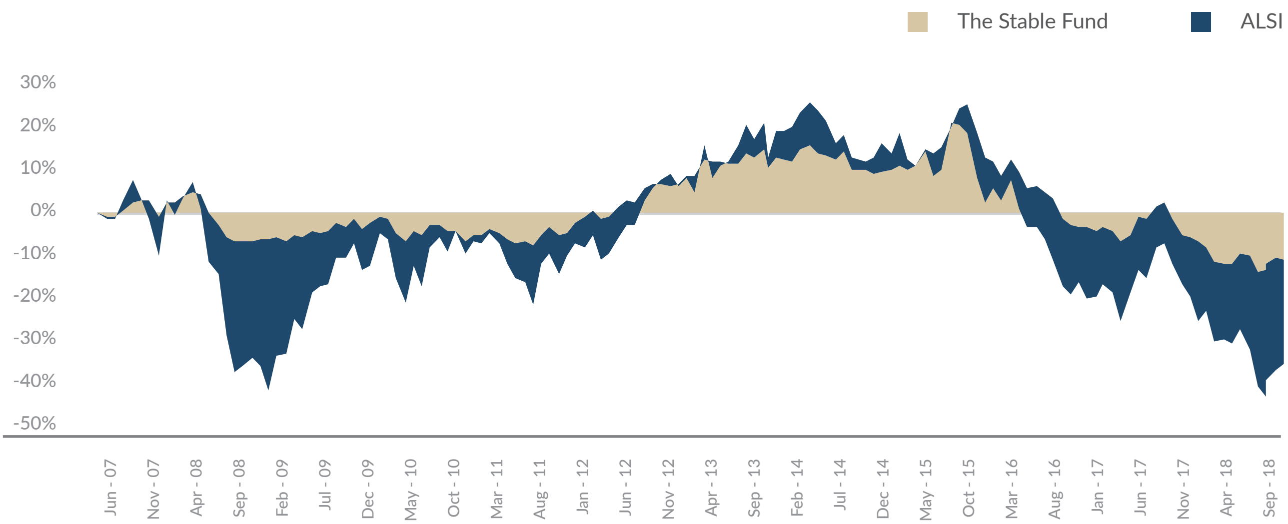
Source: Bloomberg, Maitland Fund Services (Pty) Ltd



Jonathan's journey was even more precarious. Because Jonathan started investing at the height of a bull market, his portfolio value quite often performed below expectations. Jonathan's investment into the ALSI frequently underperformed his expectation by close to 40%. Had a chance event occurred at those critical times, Jonathan's financial well-being could have been seriously impaired. If Jonathan was wise enough to rather invest in the less volatile Stable Fund, he could also have found his portfolio value below his expectations, however, importantly, the level of underperformance would have been much more palatable. His underperformance relative to expectations would have been limited to only 14%.

Figure 10: Jonathan's investment portfolio value relative to expectations

Source: Bloomberg, Maitland Fund Services (Pty) Ltd



CONCLUSION

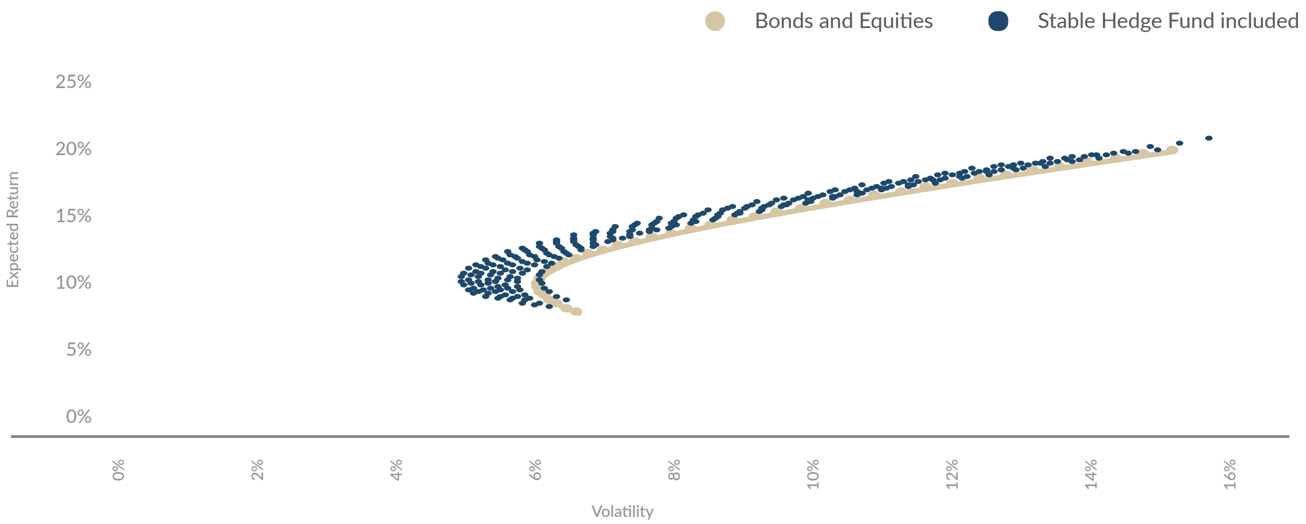
The above has been a very simplistic example of how important market volatility is in portfolio construction. We are fully aware that we have made some very simplified assumptions: for example, Nelson and Jonathan having only two investment options and only being able to invest in one and the pair never having follow-up meetings with their investment advisor to discuss the portfolio performance and re-align their expectations.

We are also aware of the pitfalls of using past market returns to highlight the investors' experience, as a historic series of events will definitely not recur. But we do believe that this very simple example highlights just how important it is for investors to consider the volatility of a fund or a portfolio.

Diversification is key in lowering volatility and it is therefore critical for an investor to optimise their portfolio on the risk/ return spectrum. It is in this portfolio construction where hedge funds can again play an important role in optimising your portfolio. Due to the low correlation of hedge funds to the other main asset classes (i.e. equities and bonds), an optimal portfolio in SA will almost always benefit from adding some hedge-fund exposure. This is clearly evidenced in Figure 11 below, depicting the efficient frontier graph.

Figure 11: The efficient frontier for bond, equities and the Stable Fund

Source: Bloomberg, Maitland Fund Services (Pty) Ltd



Hedge funds are very useful investment alternatives available to investors. They should be well understood and not be entered into without some very good guidance and research. However, ignoring the benefits of hedge funds will almost definitely make an investment portfolio suboptimal.

ANCHOR INSIGHTS

The most difficult thing in investing

Written by: MATTHEW STROUCKEN
Portfolio Management

Matthew is a portfolio manager at Anchor and has been with the business since 2012. He started out as an analyst in the investment team and now manages money on behalf of high-net-worth individuals in the portfolio management team.

There is a generally held belief in investing that there is no more powerful force than the power of compounding. Albert Einstein referred to it as the eighth wonder of the world, noting that, "he who understands it, earns it … he who doesn't … pays it". Without questioning this statement (after all, Einstein was a smart guy and the notion is absolutely true), it implies that we have to stay invested. By this I mean that we can only benefit from the power of compounding if we are invested long enough to see it work its magic

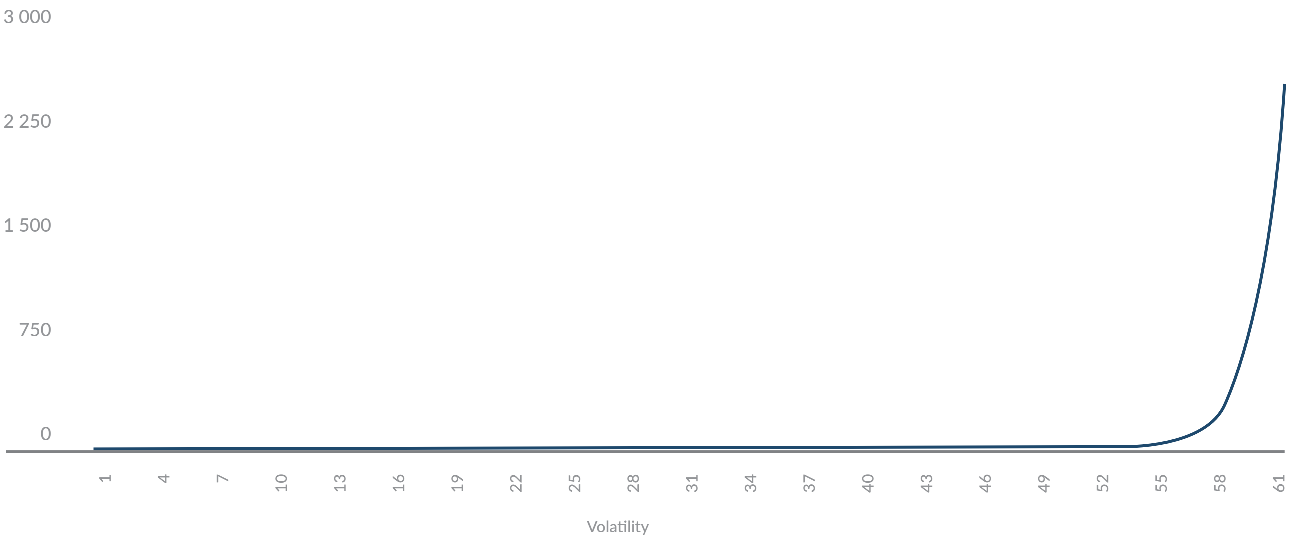
During several recent conversations with non-financial (and even some financial) folk, I've been struck by how poorly many of us understand compounding - not only what it is but also what it can do over an extended period. So that we're all on the same page: compound returns are the returns you earn on the returns you've already earned. In other words, if you invest R100 and earn a return of 10% in the first year, you earn R10 and have R110 at the end of that year. If you earn a further 10% in the next year, you earn R11. You've earned a return on the original R100 you invested and the R10 return you earned last year.

Albert Einstein referred to it as the eighth wonder of the world, noting that, "he who understands it, earns it … he who doesn't … pays it".

Over many years this is an *extremely* powerful force, just ask the man (according to legend) rewarded by a Chinese emperor with one grain of rice doubled for every square on a chess board. There was not enough rice in China to pay him. The emperor, like many of us, did not grasp the power of compounding. One grain of rice doubled for every square on a chess board (there are 64) results in 18,446,744,073,709,551,615 grains of rice. That's 18 quintillion grains of rice. To put that in context, there are an estimated 7.5 quintillion grains of sand on earth (deserts and beaches included). Figure 1 below illustrates the effect of the doubling.

Figure 1: The power of compounding returns

Source: Anchor



The important point to note from Figure 1 is not the absolute number, but rather the massive change in the number from year 56 to year 64. Imagine if this was your investment. It seems as though the value doesn't move for 56 years then, suddenly, it takes off. This is what happens when we stay invested for long periods.

The South African stock market has returned an average of around 14% per year since data began being recorded. If you are 55 years old today and had been investing R1,000 per month since age 25, you would have just under R6mn today.

If you keep making that same R1,000 monthly investment for the next ten years and stay invested until the age of 65, you would have around R24mn with which to retire. In other words, over the additional ten years you would have contributed only R120,000 but your investment value would have increased by R18mn. Over the 40 years of contributing to your investment, you would have invested R480,000 and earned over R23mn in compound returns.

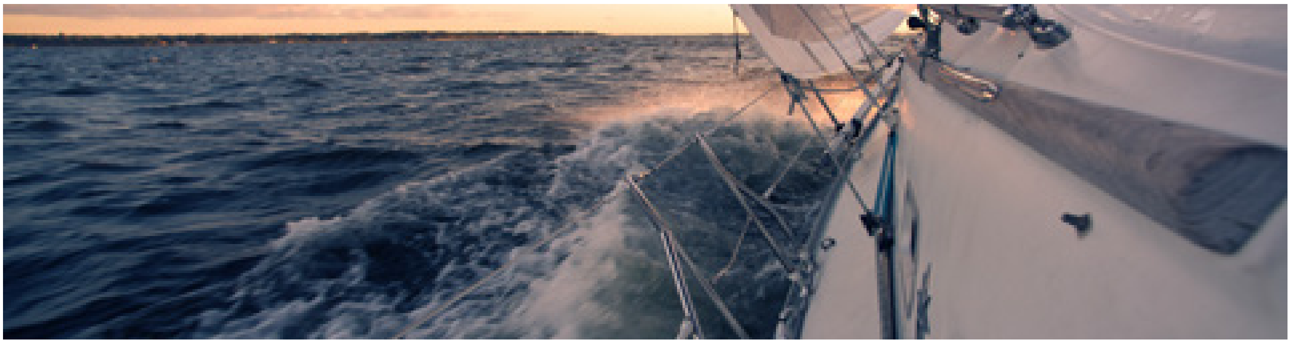
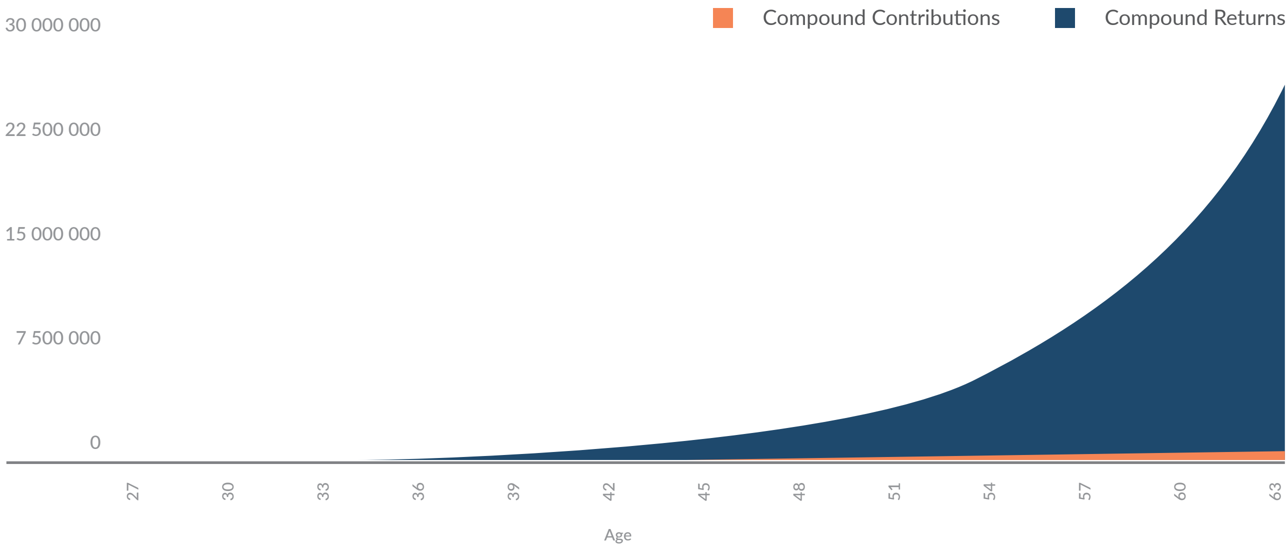


Figure 2: Contributions vs compound returns

Source: Anchor



This is a pretty handy outcome. Unfortunately, it's one few people achieve.

If the power of compounding is the most powerful force in investing, then staying invested is the most difficult thing in investing. We have numerous behavioural biases (pre-existing inclinations or ideas that influence the way we see things and make decisions), which make us almost wired not to remain invested.

We tend to withdraw money at the time of greatest pessimism (the current environment is a good example, as is the GFC of 2008); we place too much emphasis on our most recent experience; and we experience losses far more intensely than we experience gains.

These are just a few of the behavioural biases we face as investors.

The best way for us to overcome these is to treat our portfolios as truly long-term investments. This means we buy with a long-term view, we don't get swayed by short-term headlines and price movements, and we always refer to our original goal – taking advantage of the power of compound returns.

There are many examples throughout history that show the value of this approach. The 2008 crash is one and the drop in the market during the fourth quarter of 2018 is another. The pain of 2008 is well known. During the last quarter of 2018, the market was down nearly 10%. Many investors felt the pressure and chose to pull their money out of the market. Since that point in mid-December, the market is up over 13%. Since the 2008 high (i.e. not the bottom of the crash), the market is up over 70%. Those who withdrew their money at the height of the pain during either example, had the worst experience and suffered material losses. Those who rode out the volatility and remained invested, made back well more than they were down. A long-term view and focus on the original goal paid off.

One of the reasons clients pay us to manage their money is to ensure they don't get sidetracked on the journey to achieving their long-term goals. We understand that the journey is fraught with obstacles and change. We are here to help you navigate that change and to benefit from the magic of compounding returns.

ANCHOR INSIGHTS

Wills, deceased estates and the process that follows.

Written by: DI HAIDEN
CEO: Robert Cowen Investments

Di is the CEO of Robert Cowen Investments, a subsidiary of Anchor, and has been at RCI since 1990.

As the saying goes, there are only two certainties in life: death and taxes! Unfortunately, often these two go hand in hand and most people have no idea as what to do or what is expected when a death occurs. At RCI, with 37 years of looking after families and their wealth, we have built up a fount of knowledge as to what happens when someone passes away and the process that unfolds thereafter. Below, we highlight the main points of the process, which is usually complicated and lengthy, to give the reader an idea of what is involved.

WILLS

The process starts (hopefully) with the drawing up of a will. If someone dies without a will, he/ she dies intestate and this makes the process even more complicated!

So, when do you need a will? When you have **assets** and **important people** in your life. Why do you need a will? To leave your **assets** as you see fit to the chosen **important people** in your life.

Why do you need a will? To leave your assets as you see fit to the chosen important people in your life.

When writing a will you need to consider the following: Who will inherit your estate, who will be the executor/s, will you establish a trust in your will and, if so, who are the trustees, what are your assets and do you want to leave anything in particular to one heir or a number of heirs? An individual must remember that a will can be changed at any time as you go through different circumstances and phases in your life so your first will is not necessarily set in stone.

ESTATES

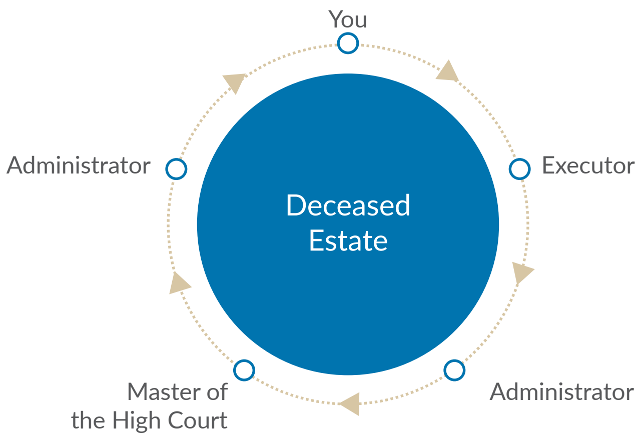
An estate is the total of all your assets less your liabilities i.e. anything you possess in your own name less your debt or borrowings. What is not your estate? Very simply put, whatever assets you have accumulated which are NOT in your name e.g. in a Trust.

Someone dies, what happens next?

The process starts as soon as there is a death. A funeral home is called in to prepare the deceased's body for burial or cremation and, most importantly, to obtain a death certificate from Home Affairs. The process of winding up an estate, can only start once a death certificate has been issued. In Figure 1, we show the important people involved in winding up an estate and below we highlight each person's role in the process.

Figure 1: The people involved in winding up an estate

Source: RCI



You – This is the person responsible for making sure an estate is wound up. It is often a close family member or friend of the deceased.

The **Executor** is the person named in the will as being responsible for winding up the estate. An Executor has to be above 18 years of age, and You and the Executor may or may not be the same person. A professional institution such as a bank, financial advisor etc. can also be the Executor. If the deceased has nominated an individual then, upon date of death, that person may make use of a third-party to assist with the duties of an Executor of the estate.

Often the Executor appoints an **Administrator**, who is a professional at winding up estates. Since the process is specific and complicated it is preferable not to do it yourself.

The Administrator deals with the **Master of the High Court (Master)**, who is pivotal in approving the winding up of the estate. An estate cannot be wound up (except for very small estates), without the Master's consent.

An estate cannot be wound up (except for very small estates) without the Master's consent.

As indicated by the flow of the circle in Figure 1 – You deal with the **Executor**, the Executor outsources the administration of winding up the estate to the **Administrator**, the Administrator deals with the **Master**, the Master reverts back to the Administrator who reports back to the **Executor**, who then comes back to You unless you are the Executor.

Essential documents in an estate

There are several documents required to start the process of winding up an estate as well as documents produced to finalise said estate. These documents include: A valid and original will, the death certificate and deceased's records are supplied by You, a letter of executorship from the Master, SARS provides a tax-clearance certificate after tax returns have been submitted and the Executor lodges a Liquidation and Distribution (L&D) account, drawn up by the Administrator, with the Master.

TIMELINE

Currently, the time taken to wind up an estate in Gauteng is c. two years. In Figure 2 and below, we summarise the sequence of important events:

Figure 2: Sequence of important events

Source: RCI

1. The burial ceremony of the deceased takes place.
2. A death certificate is issued by Home Affairs.
3. The Executor/ Administrator starts winding up the deceased's estate.
4. The estate's assets are frozen from the time of death until the Master issues a Letter of Executorship. Once issued, interim distributions may be permitted by the Executor.
5. The Administrator applies to the Master for the Letters of Executorship to be issued (currently it takes 4 months).
6. The Executor gives the Administrator a power of attorney (POA) to wind up the estate.
7. Once letters are issued the Administrator 'gathers' all assets, liabilities etc.
8. The Administrator then draws up the L&D Account, which is submitted to the Master.
9. Once there are no objections, and the Master approves the L&D account, the estate is wound up and assets are distributed to the deceased's heirs.

COSTS

There are several fees/costs to be paid by an estate:

1. Executors' fees: There is a statutory fee of 3.5% of the estate's value charged by the Administrator.
2. A final tax amount (of the deceased) has to be paid to SARS
3. Estate duty: The first R3.5mn of an estate is exempt from estate duty, however, from R3.5mn to R30mn is taxed at a rate of 20%, while R30mn-plus is taxed at 25%. If a spouse inherits, no estate duty is payable until that person's death and the R3.5mn rolls over to the surviving spouse.

WHAT CAN RCI DO?

1. We run the process for you – this entails dealing with **you**, being the Executor and/ or dealing with the Executor/ Administrator and ensuring that progress is made in winding up the estate as timeously as possible.

2. We also negotiate the Administrator's fees and we try to reduce this cost.

3. We create a legacy file to hold all relevant information related to the deceased's estate.

We understand the people involved in a deceased estate and the process but, most importantly, we know how money works in winding up an estate. We have found that each person's situation is unique, and one needs to understand how all the above applies to your individual circumstances.

In this note we have only scratched the surface of a very complex subject so we would suggest contacting RCI directly if you would like to have a conversation about any of the above-mentioned processes.

*RCI is part of the Anchor Group

Performance Summary

	FUND PERFORMANCE							BENCHMARK PERFORMANCE					
	Start date	Annualised p.a. (%)	Since inception (%)	12-month (%)	6-month (%)	3-month (%)	Mar 2019 (%)	Since inception (%)	12-month (%)	6-month (%)	3-month (%)	Mar 2019 (%)	Performance vs Benchmark (%)
UNIT TRUSTS													
Anchor BCI Equity Fund	Apr-13	11.7	93.8	1.6	-0.1	6.8	1.6	59.7	-2.6	-0.1	3.9	-0.2	34.1
Anchor BCI Flexible Income Fund	Jun-15	7.8	33.4	8.3	4.9	2.8	0.8	32.5	7.5	3.7	1.8	0.6	0.9
Anchor BCI Managed Fund	Jan-15	3.9	17.4	3.0	0.6	6.6	1.9	20.2	5.8	1.0	5.8	1.3	-2.8
Anchor BCI Worldwide Flexible Fund	May-13	11.5	89.3	18.0	0.8	13.2	3.5	66.6	8.1	3.5	1.4	1.1	22.6
Anchor BCI Property Fund	Nov-15	-2.3	-7.7	-6.5	-4.4	-0.1	-2.2	-8.6	-5.7	-2.6	1.5	-1.5	0.9
Anchor BCI Global Equity Feeder Fund	Nov-15	6.8	25.3	19.0	-5.6	16.1	4.9	38.0	25.2	-0.4	12.5	3.8	-12.8
Anchor BCI Bond Fund	Feb-16	10.6	37.2	3.8	7.0	3.8	1.0	36.0	3.5	6.7	3.8	1.3	1.2
Anchor BCI Diversified Stable Fund	Feb-16	6.8	23.1	7.4	2.8	3.8	0.8	19.2	6.7	2.1	4.0	1.0	3.9
Anchor BCI Diversified Moderate Fund	Feb-16	5.5	18.4	6.1	1.4	4.4	0.7	16.8	6.5	1.3	5.3	1.2	1.6
Anchor BCI Diversified Growth Fund	Feb-16	4.3	14.2	4.4	0.2	4.9	0.6	16.3	5.8	1.0	5.8	1.3	-2.1
Anchor BCI Africa Flexible Income Fund	Mar-16	6.7	22.0	16.7	5.9	6.4	2.5	32.0	9.3	4.5	2.2	0.7	-9.9
EQUITY NOTES & SEGREGATED MANDATES													
Anchor Equity	Jul-13	8.9	63.5	2.6	1.0	4.6	1.3	58.6	-2.6	-0.1	3.9	-0.2	4.9
Growing Yield*	Jun-12	10.2	92.3	1.7	0.5	0.4	-0.5	93.4	9.1	4.0	1.7	1.2	-1.1
HEDGE FUNDS													
Long Short Equity	Mar-13	7.2	52.1	1.0	3.1	3.4	0.8	59.6	8.8	4.3	2.1	0.7	-7.5
Property Long Short	Jan-14	8.2	51.3	-3.4	-2.3	-1.3	-1.5	57.7	9.7	4.8	2.4	0.8	-6.5
Anchor Accelerator	Feb-16	8.5	28.4	20.7	14.1	16.6	3.9	15.0	-2.6	-0.1	3.9	-0.2	13.5
OFFSHORE													
High Street Equity - Dollars	Jun-12	11.9	113.4	4.0	0.5	14.5	3.1	102.1	4.6	-2.4	12.6	1.4	11.3
High Street Equity - Rands	Jun-12	21.6	275.1	26.7	2.5	14.8	5.8	256.0	27.6	-0.6	13.0	3.9	19.1
Offshore Balanced - Dollars	Jun-12	10.1	91.7	4.4	1.2	10.7	2.6	55.2	2.5	0.0	8.3	1.3	36.4
Offshore Balanced - Rands	Jun-12	19.7	237.6	27.3	3.2	11.0	5.4	167.6	22.4	-0.3	6.3	1.6	69.9
Global Dividend - Dollars	Jan-14	7.8	47.3	2.7	-2.6	7.7	1.5	50.3	4.6	-2.4	12.6	1.4	-3.0
Global Dividend - Rands	Jan-14	13.4	91.1	25.1	-0.7	8.0	4.1	94.8	27.6	-0.6	13.0	3.9	-3.7
Anchor Sanlam Global Stable Fund - Dollars	May-15	0.4	1.5	2.4	1.2	5.3	1.1	10.9	2.8	1.4	0.7	0.2	-9.3
Anchor Sanlam Global Stable Fund - Rands	May-15	5.0	20.5	24.6	3.0	5.6	3.6	32.5	25.9	4.0	1.8	3.2	-12.0
Anchor Sanlam Global Equity Fund - Dollars	May-15	6.9	29.2	1.5	-5.2	18.3	4.1	30.6	7.0	2.0	15.2	4.0	-1.4
Anchor Sanlam Global Equity Fund - Rands	May-15	11.6	52.7	23.0	-4.0	25.4	12.8	54.3	29.6	3.3	22.0	12.6	-1.6

Source: Morningstar and Bloomberg 31 March 2019

*Provisional performance returns

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