August 2018

THE STERLING TIMES

THE FOLLY OF THE FIXATION ON THREE-YEAR NUMBERS

THE RAND….THE RAND… THE RAND

INVESTMENT STRATEGY FROM STERLING

CELEBRATING OUR COMMUNITY

STERLING PRIVATE WEALTH

2018 has been a difficult year so far for South Africans, both from an investment perspective, and with the continued political uncertainty. Clear, meaningful leadership is in short supply, and the continued global emerging market headwinds have resulted in a flat SA equity market.

We hope that post the 2019 election, there will be a more concrete direction and strategy from our country's leaders, as they battle to reverse the catastrophic damage caused by the Zuma administration in so many areas. This "free-for-all" looting and corruption, which really accelerated after 2014, has created a very difficult framework for inward looking SA-listed businesses to thrive. This is reflected in the fortunes of these businesses' share prices over the past three years.

RECENT OUTCOMES HAVE BEEN WEAK

The recent investment experience has planted doubt in the minds of some investors, as the risk-return trade-off did not hold. The truth is that over the five years to the end of May, investors achieved no additional return when increasing risk incrementally. Regardless of whether they invested in a low-risk money market fund, a fully invested equity fund or anything in between, the average return outcome would have been similar. The issue is amplified when one assesses returns over three years. Over this period, investors were better off in money market funds than in equity funds – investors experienced the risk, but not the return. This inevitably leads some investors to ask certain questions: is it still worth exposing my portfolio to risks associated with growth assets? Should I rather de-risk my portfolio? Or put simply: where did my return go?

A large SA Asset Manager recently concluded their second annual client survey in which they used the opportunity to ask investors a range of questions that could help create better outcomes for clients. One of the areas that they focussed on is the expectations gap: the difference between investors' expected returns and their actual experienced returns. The results can be interpreted as a barometer for how comfortable investors are about their investment choices.

On average, those investing for short-term income expect an annualised return of 9%, compared to the actual outcome of 8% and 7% per annum over three and five years, respectively, of the average flexible fixed interest fund. In contrast, those investing for growth over the long term have endured a much more disappointing experience over the last few years. The survey shows that the average long-term investor expects 12% per annum.

Compare that to the average return of your typical balanced fund of only 4% and 7% per annum over three and five years, respectively. Although one can argue that investor expectations are too optimistic and require moderation to be prudent (at the current 4.4% CPI rate, it implies a 7.6% per annum real return expectation, compared to a long term 5%-real return as the generally accepted reasonable expectation for a balanced fund), the reality is that the average balanced fund has only delivered a third of the expected return over the last three years.

Unfortunately, this expectation gap may be interpreted as justification for taking actions that could prove to be wealth destructive over time.

WEALTH DESTRUCTION IN ACTION

The need to act when expectations are not met is an understandable human response but could result in several unintended consequences when ill conceived. Selling growth assets after periods of poor performance or buying more growth assets after periods of exceptional performance is often to the detriment of growth investors over the long term.

PERSONALISED ATTENTION

We pride ourselves on staying close to our clients, coaching them through troubled times, and ensuring rational decision-making. This has always been our proposition and it remains so. Carefully considered, often contrarian and value-orientated fund and investment allocations are the optimal way to achieve long-term success. In the short term, anything can happen, and often does.

We are very proud of two high-achieving individuals in our community. The first is one of our Directors, Janet Hugo, who is a finalist in the Financial Planner of the Year competition for the second year in a row. We are confident and hopeful of Janet winning the award in 2018. Good luck Janet! We know how hard you have worked throughout the selection process.

On 6 August, one of our clients, Mike Prentice, completed the swim across the English Channel in 14 hours and 39 minutes, a truly remarkable achievement. Mike is the 63rd South African to complete this solo swim. We are inspired by your efforts Mike, what an incredible and tough feat. A top effort indeed!

We remain committed to providing highly personalized, long-term and sustainable wealth strategies to our loyal and quality client base, and to those who we hope will be joining our community soon.

Graydon Morris
Founding Director

THE FOLLY OF THE FIXATION ON THREE-YEAR NUMBERS

Returns from most major asset classes have disappointed in recent years

While almost all asset classes beat inflation over almost all periods shown in Table 1, global equity (measured in Rands) was the only asset class that gave you a healthy margin above inflation over the past three years. In addition, Naspers made up a big part of the JSE's returns over the last few years, and few active managers achieved index returns. It is understandable if investors feel unnerved. Looking out over ten to fifteen years, however, the picture improves.

Table 1: Annualised asset class returns (ZAR) to end June 2018

	3 years	5 years	10 years	15 years
Local equities	6.69%	11.05%	9.80%	17.08%
Local bonds	7.76%	7.39%	9.76%	8.73%
Local cash	7.27%	6.71%	6.94%	7.48%
Local property	0.93%	6.71%	15.96%	
Global equities	10.73%	15.15%	10.09%	10.39%
Emerging market equities	7.45%	9.58%	5.61%	12.57%
Global bonds	6.78%	8.39%	8.52%	7.97%
SA CPI (averages)	**5.39%**	**5.48%**	**5.90%**	**5.42%**

Source: Bloomberg

What's wrong with worrying about three-year returns?

Firstly, for most investors who need capital growth, this time horizon is way too short. Even at retirement, we need to be thinking well beyond three years. We need to be thinking of 30-year time horizons.

Secondly, three-year returns are simply one point-to-point snapshot. Many investors choose funds based on historic three-year returns. However, the flaw in this assessment is that it extracts only two days from a naturally volatile market's history. From that one number, investors must then try to assess the ability of a fund manager who should ideally be focused on making long-term decisions that will deliver on client needs (generally, to achieve a certain return above inflation). The reality is that even the most astute investor does not know with any precision when (or even how) these various investment theses will pay off; just that in combination, they have a good chance of doing so. This makes an arbitrary three-year return number a very imperfect starting point.

Thirdly, returns in growth assets are not smooth over shorter-term periods. Even a three-year number can vary greatly from one year to the next. (Indeed, the numbers to May told a different story!) Fixating on shorter-term returns masks the powerful impact of compounding that a consistently applied strategy can deliver over time.

Finally, these numbers are backward-looking and have no bearing on the investment opportunity currently available. We feel better when historic returns are high (even though the market may well be becoming expensive) and anxious when they are low (when in fact there may be great bargains to be bought that could generate excellent returns going forward). This is the biggest problem with putting too much score on historic three-year returns: they do not tell you whether the securities in a portfolio are trading at more, or less, than their true value, which is the most important determinant of future returns.

What is the use of historic returns then?

When considered in context, over the right period and with the appropriate level of equanimity, you can use historic returns to evaluate your strategy and assess if you need to make any changes. It would be valuable to ask the following:

- Am I looking at the right time horizon for growth assets? It is unlikely to be three years.
- What have the asset classes done over this time? That is, what was available for me to build my long-term investment strategy? Investments take place in a changing environment.
- Did I have enough diversification or should that part of my strategy be adjusted?
- Do I have enough invested in growth assets? The evidence favours long-term exposure to equities, preferably in a combination of local and global firms.
- Sure, cash looks great with hindsight. But is it practical and tax efficient to even think about being all in cash? How would I get the timing right to go back into growth assets?
- What did I miss out on and can I learn from this? An example would be government bonds, which have offered the opportunity to invest at 3% to 5% above inflation over the past few years but were scorned by many investors because of sentiment.

How best do we make sense of historic returns?

For a more meaningful assessment, look at longer-term and preferably rolling (annualised average) returns, as they are more representative. However, be realistic: there may be uncomfortably long periods during which three- and five-year returns do not meet requirements. In 2011 and 2012 for example, close to all South African balanced funds failed to achieve the generally accepted benchmark of inflation plus 5%. Over time, however, the category has delivered. Markets go through periods of lower returns and trying to time them is impossible.

Historic returns are just that

They have no bearing on investment opportunities going forward. Even if historic numbers have disappointed, investors must uphold the principles of sufficient exposure to growth assets and a well-diversified strategy. These will be vindicated if applied consistently.

The rand….The rand…The rand

There’s an old saying in markets that when the US sneezes, the rest of the world catches a cold.

Similarly, when the US throws punches, markets can get bruised. US President, Donald Trump announced that tariffs would now be implemented against $50 billion worth of Chinese imports to punish China for alleged unfair trade practices. China’s predictable retaliation led to Trump calling for an additional tranche of tariffs on another $200 billion of goods. This caused renewed jitters on global equity markets, effectively nipping a promising rally in the bud.

The US imports around $500 billion in goods from China annually, and exports only around $130 billion to China. American exports to China account for less than 1% of US GDP, while Chinese exports to the US accounts for around 4% of Chinese GDP. What the trade balance numbers don’t capture is the substantial presence American multinationals have in China, with billions of dollars in sales to Chinese consumers. General Motors (GM), for instance, sells more cars in China than in the US. These cars don’t count towards US exports as they are made in China, but the revenues accrue to GM shareholders. Arguably, the bigger impact of the tariffs is not directly on trade volumes, but more on the uncertainty it creates for businesses with complex value chains that span several countries.

A further escalation of the trade dispute would be negative for both the US and Chinese economies, and by implication the world economy. It is therefore in the interests of both countries to step back from the brink. In the US, there is a strong free trade lobby in the Republican Party, with mid-term elections looming in November. While China’s government is not democratically accountable, it is also not worried about winning elections and can take a longer-term view. During the Great Depression of the 1930s, the imposition of large tit-for-tat tariff increases worsened the global slump, but at that time policymakers were desperately searching for a way of stimulating domestic activity. Currently, however, both these economies are humming along nicely, and neither need protective tariffs.

Rand stumbles

Predictably, amid the market jitters over trade wars and the selling pressure on emerging market assets, the rand took a further beating recently. It almost touched R14 to the US dollar, before strengthening somewhat. The fact that it has now weakened 15% against the dollar since President Cyril Ramaphosa was sworn in, is clearly not because his attempts to stabilise government and the economy are failing (it is simply too early to tell). Rather, it reflects global conditions. The rand has sold off in line with other emerging market economies amid large-scale capital outflows from these markets.

Why is the rand and South African markets in general, so exposed to global market developments? There are three broad reasons. Firstly, emerging markets are increasingly being integrated into global markets.

As Financial Times commentator, John Authers put it recently, emerging markets have "developed and consolidated in many important ways since the wave of crises in the 1990s, and the disaster of 2008, but one fact remains: a large proportion of their shares and bonds, and particularly of the free float of shares, remains in the hands of foreign investors. That makes them geared to changing emotions within the developed world." When these investors are nervous, they tend to reduce exposure to relatively risky emerging markets. South Africa, with its resource dependence, has always been sensitive to the global cycle, but our broader economy has increasingly integrated with the world economy since the end of isolation in the early 1990s.

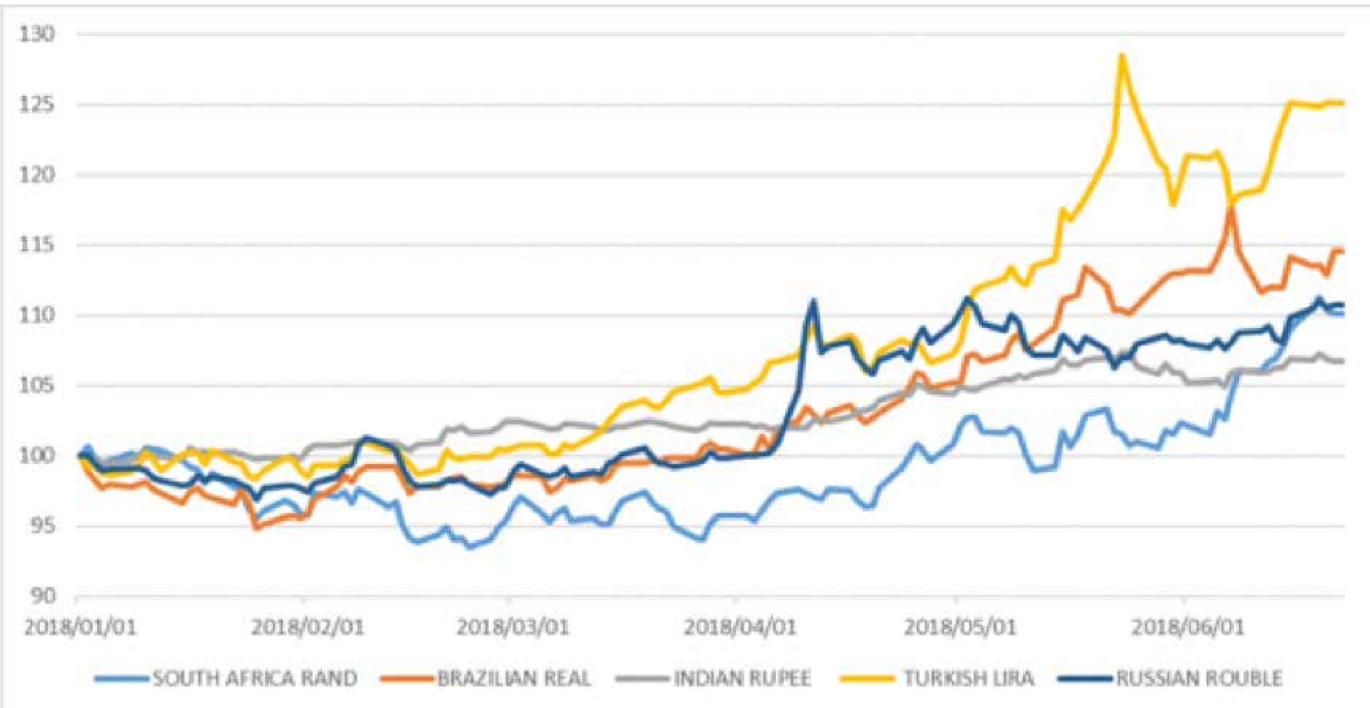

Chart 1: Emerging market currencies against the US dollar, indexed to 100

Secondly, our bond and equity markets specifically, have integrated into global markets. They are deep and liquid, and foreigners face no restrictions buying and selling (unlike locals, who are restricted by capital controls and prudential regulation). Relative to the size of the economy, our bond and equity markets are larger than those of our peers. The rand is also one of the most freely traded currencies in the world. According to the Bank for International Settlements' Triennial Central Bank Survey, the rand was number 20 in terms of world forex market turnover, ahead of larger economies such as Poland, Taiwan and Indonesia.

Being one of the more liquid currencies, the rand tends to be in the front of the queue when global investors sell out of emerging markets.

Current account deficit surprisingly large

The third reason is that South Africa needs foreign capital flows as it runs a large current account deficit. Again, relative to the size of our economy, our current account deficit is large compared to other emerging markets. New data from the SA Reserve Bank showed that the current account deficit had widened more than expected in the first quarter, increasing from 2.9% to 4.8% of GDP.

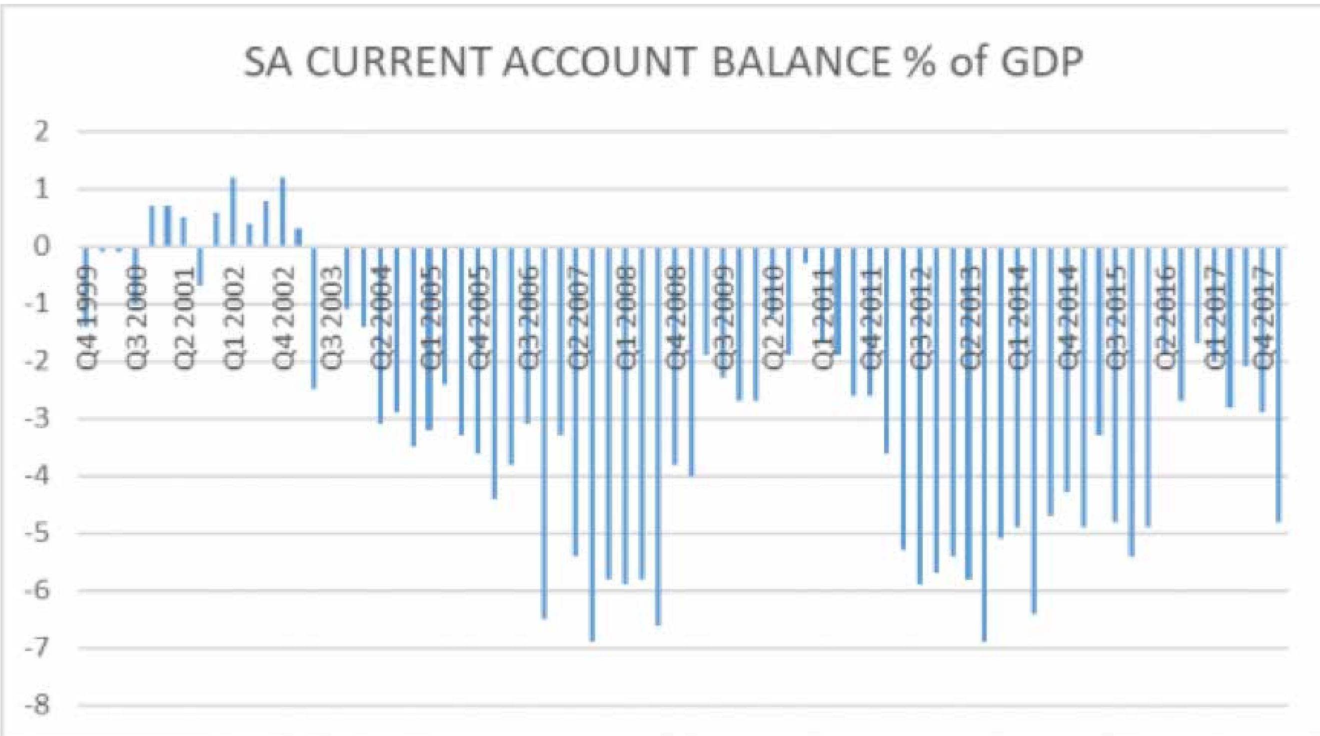

Chart 2: South Africa current account balance, % of GDP

This was largely due to the trade balance switching from surplus to deficit, as the value of exports fell more than that of imports. The former was due both to lower export volumes and the stronger rand in the first quarter. The deficit on the services, income and transfer account remains the largest driver of the current account, with the trade balance being quite volatile from quarter to quarter. It was slightly smaller than in the first quarter, as dividend inflows from abroad exceed dividend outflows during the quarter but remains very sticky at around 4.3% of GDP.

The current account balance is the broadest measure of a country's economic engagement with the rest of the world. It tracks the net flows of imports and exports (the trade balance), the net flows of services payments, (such as cross border insurance) and tourism spending. It also tracks the net income flows (dividend and interest payments) of bonds and equities owned by foreigners in South Africa and by locals abroad. The other way to think about the current account deficit is that it reflects the shortfall of savings relative to investments. South Africans don't generate enough savings across the household, business and government sectors to fund investment in the economy, so we need to 'import' savings.

This happens mostly in the form of foreigners buying our bonds and equities, which, as we've seen, they can sell in a hurry. In other words, there are benefits to a weaker economy.

Exchange rate's influence on inflation has diminished

The main cost, however, is higher inflation. The rand weakness, if sustained, should place some upward pressure on imported prices, but the overall influence of the exchange rate on inflation has diminished in recent years. May inflation was once again surprisingly low, falling to 4.4% from 4.5% in April, while the market expected an increase to 4.6%. This was despite petrol price hikes in April and May and the VAT increase, as higher fuel inflation was offset by declining food inflation. Excluding the impact of both volatile food and fuel prices, core inflation was also 4.4%.

This is a truer measure of underlying price pressures in the economy, and these are clearly still subdued. In the current environment, companies are simply not able to push through large price increases.

What does it mean for investors?

The exchange rate should not be the share price of South Africa, with a weak rand signalling domestic troubles. Investors should rather view the exchange rate as an important adjustment mechanism for the domestic economy. A weaker rand not only supports export value, but also boosts the values of South Africans' substantial foreign asset bases. The Reserve Bank also reported that South Africa had a positive net international investment position of R562 billion in the first quarter, as the value of foreign assets exceed foreign liabilities. The economy therefore has a large built-in rand hedge. This extends to local investors, and typical diversified portfolios should, on balance, benefit from a weaker rand. Specifically, our funds have substantial rand hedge exposures, directly through global equities and property and indirectly through JSE-listed companies with global operations.

OLD MEN

One evening an old farmer decided to go down to his pond, as he hadn't been there for a while. He grabbed a twenty-litre bucket to collect some fruit while he was there.

As he neared the pond, he heard voices shouting and laughing with glee. As he edged closer, he saw it was a group of young women skinny-dipping in his pond! He made the women aware of his presence and they all swam to the deep end. One of the women shouted to him, 'We're not coming out until you leave!'

The old man frowned, 'I didn't come down here to watch you ladies swim naked or make you get out of the pond naked.'

Holding the bucket up he said, 'I'm here to feed the crocodile…'

INVESTMENT STRATEGY FROM STERLING

By Janet Hugo
Director
Sterling Private Clients

Ever since the market debacle triggered by the Great Recession, "Staying the Course No Longer Works" and "Modern Portfolio Theory Is Dead" have been popular headlines in the financial media. It sounds feasible of course; after all, why would any investor willingly subject their portfolio to the massive losses of 2008 and early 2009?

Does that mean that long-term strategic investing is out the window? One of the core beliefs at Sterling is that to earn market returns, an investor needs to be in the market. Is that yesterday's story? Our Model Portfolio Investment Committee takes these considerations very seriously, and we regularly review our investment philosophy and strategies.

The critics claim that modern portfolio theory, asset allocation, and buy and hold are all equivalent concepts, and all are passé. What surprises us, is that the critics seem to believe they have just discovered some new "truth", when in reality, a new group of "gurus" discovers the same truth after every bear market. These critics typically claim that "allocations are solely and simplistically based on projected historical data and traditional methodology that assumes valuation is irrelevant; they are determined at the beginning of the investment process and are never changed, except when they are rebalanced."

Although, unfortunately, it is true that many practitioners do in fact develop allocation models based simply on historical data, that is certainly not the case at Sterling. We heed the advice of Harry Markowitz, Nobel Laureate and the father of modern portfolio theory. In his seminal work, Professor Markowitz wrote, "The first stage starts with observations and experience and ends with beliefs about the future performances of available securities." He is quite clear in rejecting the approach of using historical projections. "One suggestion as to tentative risk and return is to use observed risk and return for some period of the past…I believe that better methods, which take into account more information, can be found."

We certainly agree. When developing our recommendations for allocations to fixed interest, international assets and equity, we always also assess forward-looking estimates for the returns, risk, and relative movement (i.e. correlations) of the various investments we will consider for our portfolios.

While there can be no guarantee that these estimates will turn out to be correct, they certainly take into consideration not only the past, but also the current market environment, as well as expectations regarding future changes. For example, our projections for future returns may be more modest relative to past returns, our expectation regarding risk is that the markets will remain more volatile than in the past. We believe that we live in an increasingly global world, so markets may move more in tandem in the future than in the past. The result is that the benefits of diversification may be diminished but not eliminated.

Some criticise that allocations are determined at the beginning of the investment process and never changed, except when they are rebalanced—a strategy oft called "buy and forget". There is nothing in the extensive investment literature or in practice to suggest that a policy allocation should not be revisited and revised when and if forward-looking market expectations change. Consequently, it is our practice to review our assumptions regularly and our "strategic" allocations may in fact vary over time because of changes in our worldview. Rather than "buy and forget," our policy is "buy and manage."

"A good portfolio is more than a long list of good stocks and bonds. It is a balanced whole, providing the investor with protections and opportunities with respect to a wide range of contingencies."

- Prof. Harry Markowitz