March 2018

THE STERLING TIMES

THE INCREDIBLE RUN OF THE RAND

STEINHOFF WHAT HAPPENED?

OVER CONCENTRATION, RISK MANAGMENT AND PORTFOLIO CONSTRUCTION

INVESTING TIDBITS

STERLING
PRIVATE WEALTH

It would be fair to say that we have started 2018 with a slight spring in our step, and with more optimism and hope for our wonderful nation than we have experienced in the past number of years. This is most welcome as Sterling Private Wealth enters its 16th year.

The December 2017 ANC elective conference kept us glued to the airwaves as voting took place. The future of our country was on a tight-rope. Whilst there is much work to be done, and the outcome not perfect, the potential alternative that may have transpired remains too ghastly to contemplate. Not all of us fully appreciate how close we were to the NDZ camp prevailing and the rand trading at R16/$.

The result, though, in market terms, has been an exceptionally strong rand, a run in “SA Inc” shares and a significantly more interested global investor, particularly after Cyril Ramaphosa’s trip to Davos.

Rand Strength

Whilst the strong rand has impacted negatively of late on many of our clients’ portfolios, when measured in Rands, the US$ performance of many of our international fund holdings has been truly exceptional and we are delighted with the performance of our Global Balanced Model during 2017.

We are long-term investors, however, and continue to pay attentional to risk management and the preservation of capital. There are many speculative offerings available to investors. It remains our critical role to weed these out and partner our investors in a sensible and sustainable strategy.

We have included a piece dealing with the recent rand strength, as well as a well-considered article by Karl Leinberger, CIO of Coronation, detailing the considerations Coronation deliberated when making the Steinhoff investment allocation. We value Coronation’s honesty and frankness within this assessment.

Steinhoff

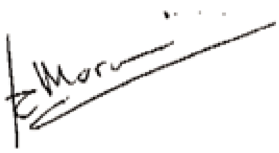
There are many who have used the Steinhoff saga to attempt to score short-term PR points. In many cases luck played a role and this opportunism is in poor taste. The wheel turns in the world of investments and undue arrogance and competitor bashing often returns to haunt one.

We are pleased that the impact on our clients in terms of this saga has been negligible and in many cases, absent.

Concentration risks

We have included an article by Adam Ebrahim, highlighting the concentration risks in the SA equity market as well as the property index. This is suddenly becoming more relevant as the Naspers share price slowly unwinds after an amazing rally, distorting our market.

We look forward to addressing your planning strategies with you all during the year.



"If past history was all that is needed to play the game of money, the richest people would be librarians."

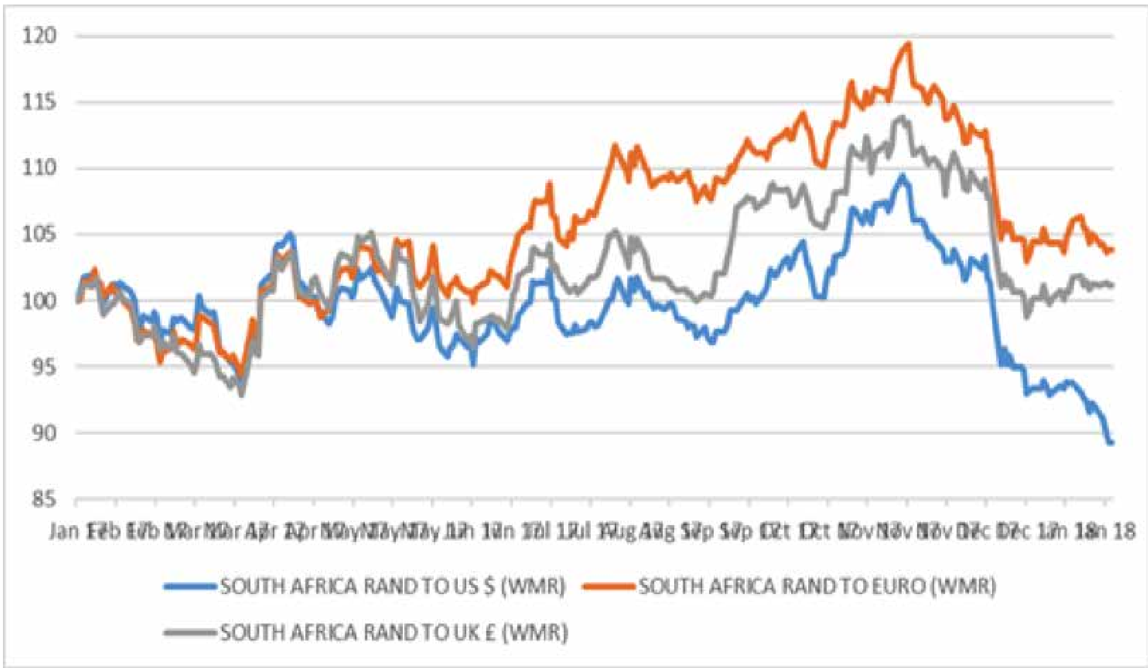
— Warren Buffett

The incredible run of the rand

Amid much fanfare, the rand broke through to R12 to the US dollar for the first time since May 2015. At first glance, it appears to be a continuation of the “Ramaphosa rally” as investors price in improved prospects for economic reform, policy certainty and corruption fighting. However, as is mostly the case, the global backdrop is crucial. After all, the rand has strengthened 4% against the US dollar this year, but is flat against the euro and weaker against the pound.

In other words, this is a weak dollar story, though the new positive sentiment towards South Africa certainly helps. Other emerging markets have also seen their currencies rally against the dollar.

Rand versus major currencies



Source: Datastream

**Rebased to 100*

Greenback back to earth

The dollar surged from 2011, as the US economy grew much faster than its peers and markets anticipated interest rates rising from near-zero levels. The first of these hikes by the US Federal Reserve came in December 2015. This was a few days after markets and politics collided forcefully in South Africa, when finance minister Nene was fired out of the blue, at the worst possible time in terms of global risk appetite. But since the Fed has started hiking (with five in total, taking the funds rate to 1.50%) the dollar has declined, apart from a brief spike following the election of Donald Trump as US president. The sell-off has accelerated since the start of the year.

Why is the dollar sinking, given that a country with strong economic growth and rising interest rates normally sees its currency appreciate? Moreover, the other central banks – the European Central Bank (ECB) and the Bank of Japan – still have an extremely accommodative policy stance with negative interest rates, which both reiterated last week. The Bank of Japan last week held steady on interest rates (-0.1%) and its policy of buying bonds to keep the 10-year government bond yield close to 0%.

The ECB kept interest rates on hold and its bond-buying programme will remain in place until at least September with the aim of getting Eurozone inflation higher. A strong euro – it hit $1.25 for the first time since December 2014 – works against the ECB's aims by putting downward pressure on inflation and hurting the revenues from the Eurozone export machine.

The explanation probably lies in the fact that it is expectations that mostly drive currency markets, not necessarily current interest rate differentials (which are still massively in favour of the dollar). The market priced in higher US rates long before they arrived (starting in 2011 already). In other words, even though the ECB and Bank of Japan are currently accommodative, their next move is expected to be a tightening of monetary policy.

It also doesn't help that there is an element of dysfunction in US politics, as last week's brief government shutdown showed. In contrast, when the dollar was surging, the dysfunction was in Europe (which was struggling to cobble together a solution to the Greece crisis) and places like Brazil. Last week Trump's Treasury Secretary Steven Mnuchin said that a weak dollar would be good for America to close its trade deficit (he is not wrong, but his predecessors usually held the line that a strong dollar was nevertheless preferable). But he was quickly contradicted by his boss.

Finally, global investor risk appetite is high, as surging equity markets illustrate. When investors are fearful, they tend to look for safety in the US (the dollar surged during the global financial crisis). However, when fear recedes, they look for opportunities outside the US. There is an element of feedback, since a weak dollar is also beneficial to the giant multinationals listed in New York.

Can the dollar weakness (and hence rand strength) persist? From a valuation point of view, the trade-weighted dollar is still above its long-term average and therefore still has room to decline. Bullish investor sentiment towards emerging markets is another support for the local currency. If new leadership in government can follow through with some quick-win reforms, the rand could hold its own. It is probably not overvalued against the dollar yet, and has a history of overshooting on the up (as it did on the way down).

Trade-weighted US dollar index

"It's waiting that helps you as an investor, and a lot of people just can't stand to wait. If you didn't get the deferred-gratification gene, you've got to work very hard to overcome that."

— Charles Munger

Improved inflation outlook

What does the stronger rand mean for South Africa? For one thing, it lowers the cost of imported items priced in dollars (less so for items priced in euros, see chart 2). Therefore, it softens the blow of the higher oil price. After December's petrol price jump, January saw a cut and February is on track for another reduction based on the current average over-recovery of 30 cents per litre.

Consumer inflation in December rose slightly to 4.7% due to the petrol price hike. December petrol inflation was 14%, but should decline in the coming months. Food inflation declined to 4.8%, while it was running as high as 11% at the start of the year. This is particularly helpful for poor households, which spend most of their income on food. The inflation rate for the poorest 10% of the population declined to 1.6%. Wealthier households spend the largest part of their incomes on services. The inflation rate for the highest earning 10% was 4.9% in December. Insurance (including medical aid, short-term and life cover) is a big driver of overall inflation. It has a 10% weight in the CPI basket and increased by 8% year-on-year. The biggest item in the basket – actual and implied rent – saw lower inflation rates in December, indicative of a weak housing market.

Core inflation – excluding volatile food and fuel prices – fell to 4.2%, the lowest level since December 2011. The evidence of the strengthening rand since early 2016 is visible in low inflation rates for clothing, household appliances and new vehicles.

Producer inflation ticked up to 5.2% due to higher petroleum prices. Producer inflation was only 3.9%, excluding petroleum products, showing that there is limited upward pressure in the inflation pipeline.

This means that the Reserve Bank could cut rates once or twice, once the risk of the February Budget and Moody's subsequent ratings decision has passed. If the Budget delivers tax hikes as expected, it strengthens the case for the Reserve Bank to lower interest rates to ease the pressure on consumers. However, the Reserve Bank's insistence on maintaining relatively high real interest rates (around 2%) means deep cuts are unlikely. It is also increasingly focused on getting inflation to the mid-point of the 3% to 6% target range, rather than just below the upper-end.

South African inflation

A stronger rand is obviously negative for export earnings. Every dollar earned abroad is now worth less. Fortunately, the prices of commodities – accounting for about half of export revenues – have been relatively buoyant, reaching new cycle highs.

Portfolio impact of the rand movements

The stronger rand is clearly good for interest rate-sensitive assets, and bonds have rallied 2.2% this month already. However, longer-dated bond yields are still attractively high, above the average of the past decade and well above inflation, offering prospects for decent real returns.

The impact on equities and property is likely to be mixed. At an index level, a strong rand is negative as the main indices (All Share, SWIX, Top 40) are dominated by rand hedges. But the rand is obviously not the only factor driving the local equity market. The prices of the big non-resource rand hedges on the JSE will take their cue from global equity markets, while mining companies will be influenced by commodity prices. Domestically-focused shares should benefit from the improved interest rate outlook as well as the moderate economic recovery.

At an index level, listed property on the JSE has seen a substantially increased exposure to offshore earnings over ten years, from virtually nothing to 40% (mostly in Europe).

Three of the largest offshore property companies (soon to be two, after a merger between Intu and Hammerson) on the JSE are not in the benchmark index. They are, however, in the investible universe of property fund managers and therefore most likely in many investors' portfolios. This pushes the total offshore exposure to beyond 50%. Listed property had a torrid start to the year as the Resilient stable of companies came under pressure.

Currency appreciation will reduce the rand value of dollar assets, such as the 25% offshore exposure most balanced funds hold. But the dollar values of these assets are still increasing and the rand will one day depreciate again, we just don't know when. Therefore, now as ever, investors need to be patient. In the same way that overreacting when the rand crashed was a bad idea, they need to avoid a knee-jerk response to the currency's newfound strength. It is important to remember that local political developments cause short-term moves in the rand, while global factors will shape its longer-term trajectory.

STUFF NO-ONE NEEDS TO KNOW

1) How long did the Hundred Years' War last?

2) In which country are Panama hats made?

3) From which animal do we get cat gut?

4) In which month do Russians celebrate the October Revolution?

5) What is a camel's hair brush made of?

6) The Canary Islands in the Pacific are named after what animal?

7) What was King George VI's first name?

8) What colour is a purple finch?

9) Where are Chinese gooseberries from?

10) What is the colour of the black box in a commercial airplane?

Answers on page 23

"I am proud to be paying taxes in the United States. The only thing is — I could be just as proud for half the money."
— Arthur Godfrey, entertainer

Steinhoff, - what happened?

by Karl Leinberger, CIO of Coronation Fund Managers

STEINHOFF, THE GLOBAL discount retailer with more than 11 000 stores in over 30 countries, suffered a spectacular share price collapse during December 2017. The company was one of the largest listed on the JSE. Our equity and multi-asset class funds were invested in Steinhoff equity to varying degrees, depending on the mandate of the fund.

A concise chronology of events is as follows:

In the period leading up to the release of Steinhoff's full-year results, several public allegations of impropriety at the company were made. The first came in an article published by the German Manager Magazin on 24 August 2017. Most of the issues in this article had been previously disclosed by Steinhoff, or were known by the investment community.

These included a history of numerous acquisitions, an ongoing legal dispute between Steinhoff and Andreas Seifert (the owner of its former joint venture partner XXXLutz) over the ownership of certain of its European retail operations, and the allegation that losses were being incurred in off-balance sheet entities. Steinhoff responded immediately by refuting the allegations on the JSE news service, SENS.

On 18 September 2017, Steinhoff released an announcement stating that Seifert had asked a Dutch court to review Steinhoff's financial statements. It was challenging the appropriateness of consolidating the aforementioned retail business that Seifert believed he still partly owned. This announcement was no major surprise, given that the legal battle between the two parties had already been disclosed. Steinhoff management was adamant that the counterparty had a weak case.

In addition, Steinhoff had already raised a provision in its accounts to cover the cash amount required to settle the case should the company be wrong in its assessment of the likely outcome. In the announcement, Steinhoff reminded stakeholders that its financial accounts had received an unqualified audit opinion from Deloitte and that the company remained confident that the case would be dismissed.

A second news article, this time on Reuters, appeared on 8 November 2017 – two days after the company had entered a closed period ahead of the release of its financial results due early in December. This article raised some new allegations, one of which was serious: that Steinhoff held an undisclosed interest in a company called GT Branding Holding – a company whose 100%-owned subsidiary (GT Global Trademarks) had previously purchased certain Steinhoff brands. Since Steinhoff was in a closed period, it was constrained in its ability to respond to the article.

Its only response therefore was a communication on SENS in which it vigorously defended the independent nature of the parties with whom it had transacted and its accounting treatment of the relevant transactions.

On 4 December 2017, with stakeholders expecting the release of Steinhoff's financial results and clarity over the allegations, the company surprised the market by announcing that the results scheduled for release would be unaudited. Two days later, the resignation of CEO Markus Jooste was announced. This confirmed the market's biggest fears and sparked a collapse in Steinhoff's share price (amounting to a breath-taking 89% decline in that week).

The almost complete absence of any useful information from the company at a time when confidence in its financial position and creditworthiness hung in the balance, spoke volumes.

"When the tide goes out, you can tell who's swimming naked."
— Jimmy Buffet

WHERE DO WE STAND NOW?

At the time of writing, stakeholders find themselves in an information vacuum. Possible outcomes range from the best-case scenario of tax evasion and inadequate disclosure of related-party transactions to that of sophisticated fraud orchestrated by the CEO. The former would result in a material, albeit manageable, reduction in Steinhoff's intrinsic value. The latter holds much more serious implications for the long-term future of the company.

Until we have a better understanding of the nature and scale of these improprieties, we simply cannot speculate further. Without such information, and an understanding of how the banks are responding to the crisis, it is just not possible to value the company with any conviction. The stock could just as easily be worth more than the current market price as it could be less. At current prices, we are therefore likely to retain our equity holding in the company until more information has been made available publicly. At this stage, we are expecting that to be by the end of this month (31 January).

There is no doubt that many parties will litigate against Steinhoff and its auditors. Until the full nature of what occurred is known we cannot commit to our actions in this regard; however, we will be sure to act in our clients' best interests.

Finally, it is important to highlight that none of our portfolios have exposure to any debt or convertible instruments issued by Steinhoff.

WHY DID SO MANY OUTSIDERS MISS THIS?

Many observers are asking why such an extensive list of outsiders (equity and debt investors, banks, auditors and rating agencies) would be taken in by Steinhoff. In the dramatic and emotive events of December, it is easy to forget that indications of impropriety only surfaced in the very recent past. This is a company that thrived for almost two decades, notwithstanding the stress test of the global financial crisis (which did put pressure on the company, given its numerous European operations and its significant debt issuance to European investors) and the increased scrutiny that came from pursuing, and then achieving, a primary listing in Europe (which requires such steps as producing a listing prospectus). From its humble beginnings as a midsized manufacturer of furniture, it grew to become the second largest household goods retailer in Europe – a company with 130 000 employees, €13 billion in turnover and more than 11 000 stores.

At this stage, with the nature and scale of the improprieties still unknown, the question is, of course, impossible to answer. However, when the information is finally disclosed, we believe that one should consider it in the following context:

If this is a case of serious fraud, it would have been highly sophisticated and well concealed. It is highly likely that the audited financial results misrepresented the facts. Somehow Deloitte, which is a top-four audit firm with access to all the internal information it needed to perform those audits, did not pick this up.

Even an independent review by a second audit firm that, we understand, was commissioned by the Board to investigate the allegations, came out clean. Finally, David Young, a professor of accounting and control at graduate business school INSEAD who analysed Steinhoff's financial statements post the events of December, concluded that these off-balance sheet structures could not have been uncovered using the group's annual financial statements or other publicly available information.

A vast number of insiders, who by definition had better information than outsiders, were heavily invested in the company and blindsided by recent events. This was an owner-managed company that had an unusually large number of its executives heavily invested in the company and fully aligned with shareholders' interests.

We rank the company as high as second on the JSE in terms of breadth and depth of share ownership among its executives. Not only were its executives heavily invested; many kept buying Steinhoff shares right up until its collapse in December (the Chief Financial Officer, who subsequently resigned in early January 2018, bought R4 million worth of shares as late as early November). Even more unusual is the fact that very few executives ever sold shares. This is very rare for a listed company: staff who receive shares as part of share schemes usually sell their stakes pretty quickly. Many of these Steinhoff insiders have now been wiped out financially.

Over time, the CEO surrounded himself with more and more highly respected businesspeople. Most were astute and experienced individuals, many of whom had no history with the company. Most of them stayed with the company right up until the events of December.

Examples include:

Sean Summers, a former Pick n Pay CEO, who managed some of the group's UK and Australian retail businesses.

Andy Bond, previously the CEO of Asda (the third largest grocer in the UK). He is personally invested in Poundland and currently manages the European general merchandise segment (Poundland and Pep Europe).

Christo Wiese, who has a formidable, multidecade track record in business. He chose to sell Pepkor into Steinhoff and then invested most of the capital he had accumulated over his decades in business into the Steinhoff group.

Jannie Mouton, who is the founder of PSG and one of SA's most respected businessmen. He joined the board in October 2002 before retiring as a director in May 2016. Steinhoff subsequently remained a material shareholder in PSG.

Louis van der Watt, a cofounder of the Atterbury group and one of the best property developers in SA. He has been a key development partner of Steinhoff in the purchase and development of a number of its European properties.

Jo Grove, who was the CEO of supply chain company Unitrans when it was acquired by Steinhoff and subsequently remained in the group in various managerial roles.

Thierry Guibert, who was the CEO of Conforama when it was acquired by Steinhoff and who is now a non-executive director. He is currently the CEO of global fashion label, Lacoste.

David Sussman, who was CEO of the JD Group for many years before it was acquired by Steinhoff. He also stayed with the company for some time after the acquisition.

Eugene Beneke, who was the CEO of Iliad Africa when it was acquired by Steinhoff. He subsequently remained with Steinhoff Africa to run its domestic building materials business.

This was a company with a strong and independent board that appeared to take its fiduciary responsibilities very seriously.

Contrary to what some may argue, we believe that Steinhoff has one of the stronger boards on the JSE. It has many astute and genuinely independent directors – most of whom have decades of relevant business or accounting experience. Attendance records at board meetings, as well as the composition and attendance of audit committee meetings, were best in class. Board members who increased our confidence in the company include:

- Dr Johan van Zyl, the previous CEO of Sanlam.

- Dr Steve Booysen, who is a chartered accountant (CA) and the previous CEO of Absa.

- Christo Wiese, who has an exceptional, multidecade track record of directorships of many JSE-listed companies (Shoprite, Invicta, Tradehold and Brait).

- Dr Theunie Lategan, who is a CA and was previously the CEO of FNB Corporate & Commercial Banking, and FirstRand Africa and Emerging Markets. He currently serves as vice-chairman for Absa Corporate.

- Thierry Guibert, a former KPMG auditor and, as previously noted, CEO of Conforama prior to it being acquired by Steinhoff. (Guibert was therefore very familiar with a material part of the European retail operations.)

- Dr. Len Konar, who has held numerous directorships of listed companies, was previously the head of accounting at the University of Durban-Westville, is a member of the King Committee on Corporate Governance and a past chairman of the External Audit Committee of the IMF.

WHAT WAS OUR INVESTMENT CASE?

For the first decade of Steinhoff's listing, we were very sceptical of the company, its numerous acquisitions and the quality of its earnings. However, over time, we gained comfort for the following reasons:

Over almost two decades the company steadily built a very impressive global business from modest beginnings: it made many astute acquisitions (Unitrans, the UK furniture retailer Homestyle, and Conforama) that delivered handsomely, despite our scepticism at the time.

The operational delivery throughout the company's history was stellar – whether one looked at Unitrans, industrial group KAP, the UK retail assets or the European retail assets.

> ***"If you are bearish or bullish long enough, you will eventually be right."***
>
> ***— Unknown***

This operational delivery was not due to a single individual. Steinhoff runs a very decentralised model; such delivery had therefore been realised by numerous high-calibre managers, many of whom were respected independent managers who had established track records outside of the group.

The defining event that changed our view of the company was its purchase of the Pepkor group in 2014. We were shareholders in Pepkor at the time of its listing on the JSE in the early 2000s. It is a formidable company, with one of the best track records in SA. It generates lots of free cash and continues to grow strongly despite a demanding base. We were very optimistic about the company's growth prospects in both SA and Eastern Europe, where the apparel market is large but the opportunity significant for a well-managed value/discount retailer. We believed that Steinhoff had bought Pepkor at a good price and that it had fundamentally changed the quality and prospects of Steinhoff.

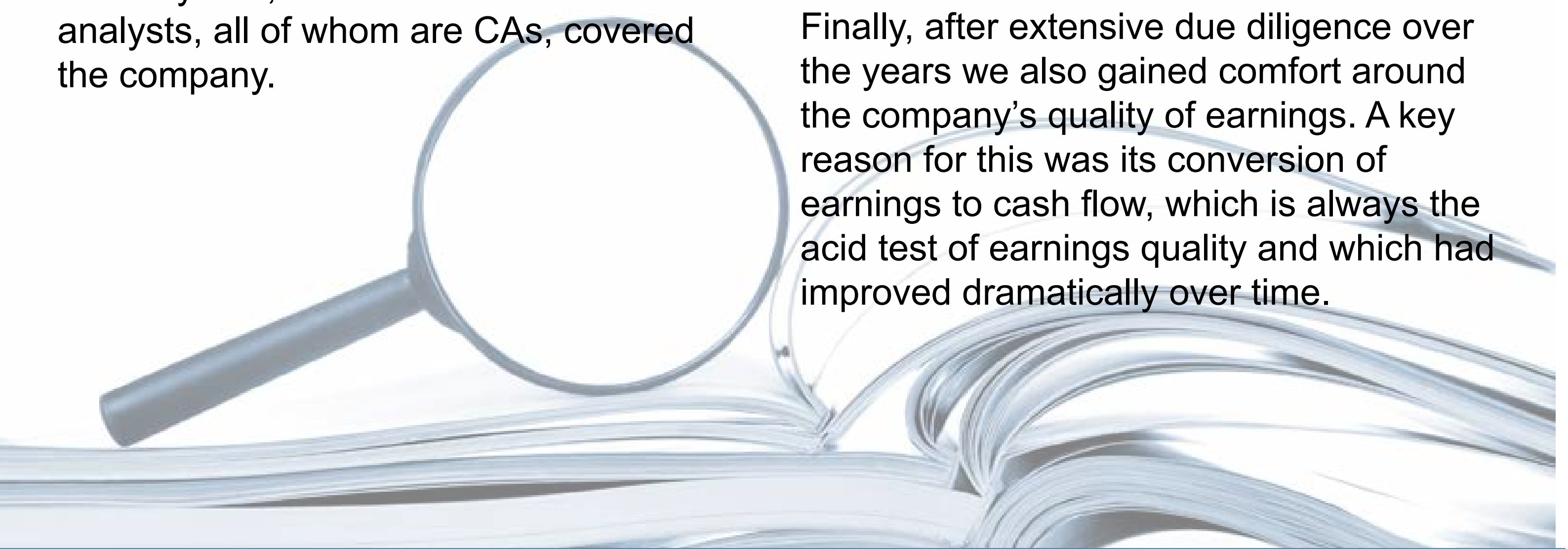
We performed extensive due diligence that extended far beyond analysis of the company's financial statements. Over the last 15 years, four different Coronation analysts, all of whom are CAs, covered the company.

We constantly challenged quality of earnings, cross-checking margins against competitors for reasonability and cross-referencing management's assertions with more junior employees of the company, non-executive board members and outsiders (typically competitors and suppliers). Although we cannot, for confidentiality reasons, disclose the names of those people, we can confirm that we spoke to at least 82 individuals during that research process (51 of those being outsiders).

Due diligence work on management always reached the same conclusion – that although this was an aggressive and entrepreneurial team, it was one that was ethical and respectful of the law. There were many sources for these reference checks, but the most compelling were always those individuals who had joined through businesses bought by Steinhoff.

The company significantly improved its board composition through the calibre and independence of its directors. The same is true of its audit and risk committee (which had three independent directors, one of whom, Steve Booysen, was chairman).

Finally, after extensive due diligence over the years we also gained comfort around the company's quality of earnings. A key reason for this was its conversion of earnings to cash flow, which is always the acid test of earnings quality and which had improved dramatically over time.



After gaining comfort on Steinhoff's investability we built our investment case, which was premised on the following points:

- An extremely undemanding valuation that we felt significantly undervalued the underlying businesses.

- Although we are highly sceptical about the prospects of most bricks-and-mortar retailers in a digital world, we believe that certain segments will be resilient to this threat. We believe that discount retail (Steinhoff's overwhelming retail format) is such an example and were of the view that the market was being too penal in its harsh rating of the company, tarring it with the same broad brush as all other conventional retailers. (We should note here that this leg of the case seems to be vindicated with indications of strong recent trading from many of Steinhoff's retail operations).

- Finally, we believed that with a heavily invested and entrepreneurial team of managers (not just the CEO, as previously outlined), Steinhoff would continue to grow the business in a fragmented market as it had throughout its 20-year history.

DID WE GIVE DUE CONSIDERATION TO THE RISKS?

As with all investments, we were cognisant of the risks inherent in the investment case, and duly accounted for them, as follows:

Low tax rate: Steinhoff's low tax rate has consistently been a concern. We took this issue seriously and questioned management in detail on the matter. Ultimately we gained comfort from the fact that Steinhoff did not use tax havens, that they had legitimate operations in certain low tax jurisdictions (such as the UK and Switzerland) and that they benefited from manufacturing tax incentives in Eastern Europe. One should also remember that many global multinationals achieve low tax rates (e.g. Steinhoff's largest competitor Ikea, as well as Richemont, Pfizer, Johnson & Johnson, Google and Apple). After recent revelations, we now think it likely that some of Steinhoff's structures crossed the line between tax evasion and tax avoidance.

Numerous acquisitions: Although many case studies of corporate failure include highly acquisitive companies, we would caution against sweeping generalisations that all acquisitive companies fail.

Many successful SA companies have been built through acquisitions – examples include SA Breweries, Bidvest and Bidcorp. Steinhoff had also increasingly demonstrated capital discipline – by walking away from the Darty and Home Retail Group (Argos) bids when pricing reached unattractive levels.

> ***"The market is not an accommodating machine."***
> ***— Peter Bernstein***

Accounting complexity: We do not believe that companies with complex financial accounts are uninvestable. It is the job of a professional investor to sift through the detail and intricacies in the task of unearthing value. Many of our greatest successes over the years have come from complex businesses with complex financial accounts.

Off-balance sheet transactions: This was a matter we took very seriously. We spent a great deal of time investigating the issue. At the time, we concluded that the motivation was tax structuring and we took account of the risk by assuming higher tax rates in the future and in our valuation of the company.

OUR ACTIONS IN THE LAST FEW MONTHS OF 2017

As soon as the allegations were made in Manager Magazin (24 August), we made contact with the magazine's editor to request the contact details of Steinhoff's former joint venture partner so that we could call him in our capacity as a shareholder of Steinhoff. The editor contacted him on our behalf, but unfortunately advised that the individual would not speak to us.

We assumed this was because the matter was sub judice.

The Reuters article (8 November) contained allegations around Steinhoff's ownership in GT Branding Holding (and that it was part of the Campion Capital Group).

This ownership stake had never been disclosed by the company (as it should have been). This was our biggest concern, because it alleged that the Campion group had also bought JD Financial Services' lending book from Steinhoff 18 months earlier. At the time we had questioned the sale with management, and the risk of an undisclosed related-party transaction, only to be given the plausible explanation that no related parties were involved and that the book had been sold to a European private equity firm with other sub-Saharan lending businesses.

The Reuters allegation was made only a few weeks before the group's financial results were due for release and the company emphatically rejected the accusation via SENS. We were unable to speak to the company (because they were in a closed period), but arranged to discuss the issue with them as soon as results were in the public domain. We took comfort from the fact that Steinhoff had a strong and independent board, one that would be closely monitoring all company announcements. In addition, both the CFO and chairman of the supervisory board (Christo Wiese) bought material tranches of shares in early November. Ultimately, we elected not to be rash and sell when we felt that the stock more than priced in many of these concerns, and especially because our base case was very much that the motivation for the structuring was tax related (and not fraud, as has become more likely with developments since then).

Conclusion

It is often said that you learn something new every day in financial markets. The current Steinhoff crisis was a lesson that we would have hoped to avoid, having had a healthy level of scepticism throughout and having conducted an enormous amount of independent due diligence.

Despite this, in the end, we still got it wrong. Although errors are part of the investment process, this one is hard to stomach. The failure of the board and the company's independent auditors to identify what is at least two years of misstated financial statements is frustrating. It is mystifying that so many smart insiders, who, by definition, had better information than outsiders, were so heavily invested in the company and so blindsided by recent events.

When more information comes to light we will be able to undertake a more comprehensive study of what went wrong and update our clients accordingly.

Finally, as much as the loss on Steinhoff is disappointing, we do take comfort from the fact that ultimately, we produce portfolios, as opposed to single-stock views, for our clients, and that our funds proved resilient in their performance, both through that first week.

"In a bear, market stocks return to their rightful owner."

— Warren Buffet

Over concentration, risk management and portfolio construction

By Adam Ebrahim

The recent collapse in the Steinhoff International share price has provided the opportune time to reflect on the fundamental pillars of portfolio construction and the effects of concentrating your portfolio in a few positions. Stocks which may appear diverse can have unexpected similar price movements if there is a significant common source of risk.

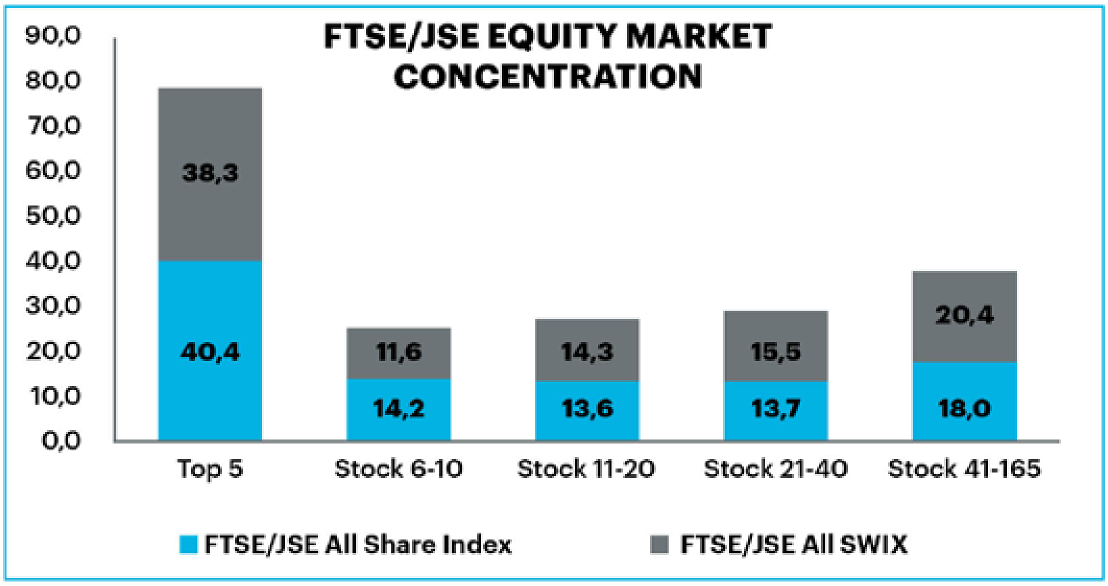
Between 5 and 7 December 2017, Steinhoff International's share price plummeted by 78%, leading to losses of up to 9% across certain portfolios of South African asset managers. During that period, the share also impacted negatively on other companies through shareholding (Star, KAP Industrial and PSG) and through a common shareholder (Shoprite, Brait, Tradehold and Invicta).

To date, Steinhoff International has lost more than 84% of its market value. Such a market event highlights the inherent risk faced by many investors and how the neglect of fundamental portfolio construction principles can have a profound impact on the savings and wealth of investors. At Oasis, we think that portfolio managers should not only worry about the implications of high volatility (implying high stock price fluctuations from the average price), but should also think of risk as the likelihood of permanent loss of investor capital.

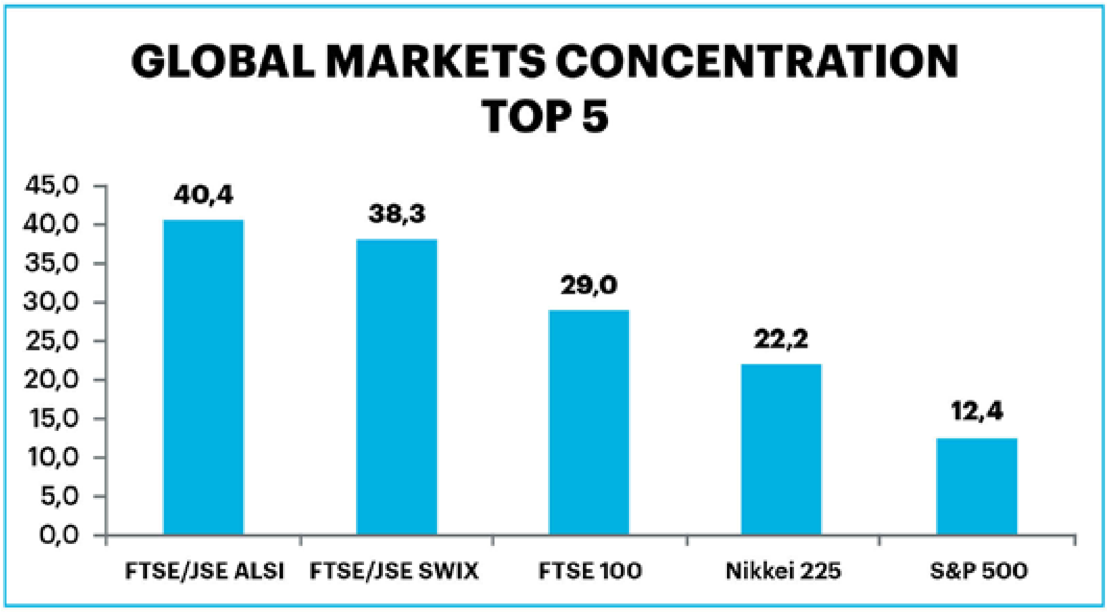
Such a view is important in investment management as it implies that it is not enough to only assess/consider the risk of a share based on the actual movement of the share price from its average price (as is done in measuring volatility), but it is important to also consider the fundamental value of a stock and see risk as the magnitude of loss to the investor from the fundamental value. The following discussion does not question investment managers' stock selection capabilities but focuses more on wealth management and the fundamentals of portfolio management.

Equity

Diversification is a key pillar of any equity portfolio construction. According to Markowitz's modern portfolio theory, combining assets that are imperfectly correlated with one another, meaning the performance of assets does not move in tandem, lowers the risk (volatility) of a portfolio and opens an opportunity for higher risk-adjusted returns. Thus, in theory investors need to (i) consider the optimal exposure they subject their investment to a single stock and (ii) how that exposure could be impacted by other positions taken in other stocks.



Source: IRESS, Bloomberg



By construction, the South African equity market is highly concentrated in a few stocks. As shown in Figure 1, the top five stocks in the FTSE/JSE All share Index (Alsi) constitute 40.4% (FTSE/JSE Shareholder Weighted index (SWIX)-38.3%) of the total market capitalisation. This implies that the South African equity market inherently exhibits a high level of concentration risk as only a few stocks have a greater chance of influencing the direction of the whole equity market.

In portfolio construction, a manager's view on the future direction of the market is reflected in the choice of the active weights assigned to different stocks making a portfolio relative to a certain reference benchmark. South African equity managers' performance is usually assessed relative to the FTSE/JSE Alsi or FTSE/JSE SWIX. Given the high concentration of the local benchmarks (Alsi and SWIX), to achieve outperformance whilst ensuring that a portfolio is well-diversified is a challenge for the South African manager. In periods where the market is largely trending up, managers as well as investors tend to overlook how portfolio returns are generated, focusing more on absolute returns (typically generated by overweighting the 'current winners').

Taking Steinhoff International as an example, Table 1 shows some of the largest exposures South African funds took on the stock:

TABLE 1: STEINHOFF EXPOSURES

No	Portfolio	Date	Portfolio Weighting
1	Ashburton Low Beta SA Composite Tracker	2017/09/30	12,5
2	Baobab BCI Flexible Opportunity	2017/11/30	9,4
3	SMM Institutional Positive Return 2	2017/10/31	8,8
4	Momentum Industrial	2017/09/30	8,7
5	Anchor BCI Worldwide Aggressive Flexible	2017/11/30	8,6

Source: Morningstar

"In theory, there is no difference between theory and practice. But, in practice, there is."
— Jan LA van de Snepscheut

As shown in Table 2, Steinhoff International has been an important stock in the major South African indices in recent years, achieving a peak weighting of 3.5% and 4.4% in the Alsi and SWIX respectively in March 2016.

TABLE 2: STEINHOFF WEIGHT IN ALSO & SWIX (%)						
	DEC 12	DEC 13	DEC 14	DEC 15	MAR 16	DEC 16
ALSI	0,9	1,4	2,3	2,9	3,5	2,8
SWIX	1,3	1,9	3,0	3,8	4,4	3,4
Source: IRESS						

However, it is not the largest stock in these indices as that position is held by Naspers with a current weight of 19.4% in the Alsi and 23.3% in the SWIX. As Naspers has delivered strong share price performance in recent years, it has become a much larger component of the indices and various funds and in that process, has raised concentration risk significantly for investors (see Table 3 below).

TABLE 3: NASPERS EXPOSURES		
Portfolio	Date	Portfolio Weighting
NewFunds NewSA ETF	2017/09/30	38,1
Satrix Indi ETF	2017/09/30	34,7
NewFUnds SWIX 40 ETF	2017/09/30	26,8
Satrix Swix Top 40 ETF	2017/09/30	26,5
SMM Equity Index	2017/10/31	23,6
Nedgroup Inv Rainmaker	2017/09/30	20,5
Allan Gray Optimal	2017/09/30	20,5
Syngia Active Equity	2017/09/30	20,0
SIM General Equity	2017/10/31	19,8
STANLIB SA Equity	2017/09/30	19,7
ALSI	2017/12/29	19,4
SWIX	2017/12/29	23,3
Source: Morningstar/IRESS		

We are not questioning the quality of the Naspers business but strongly believe that investors who are looking for long-term sustainable returns should consider the following two questions:

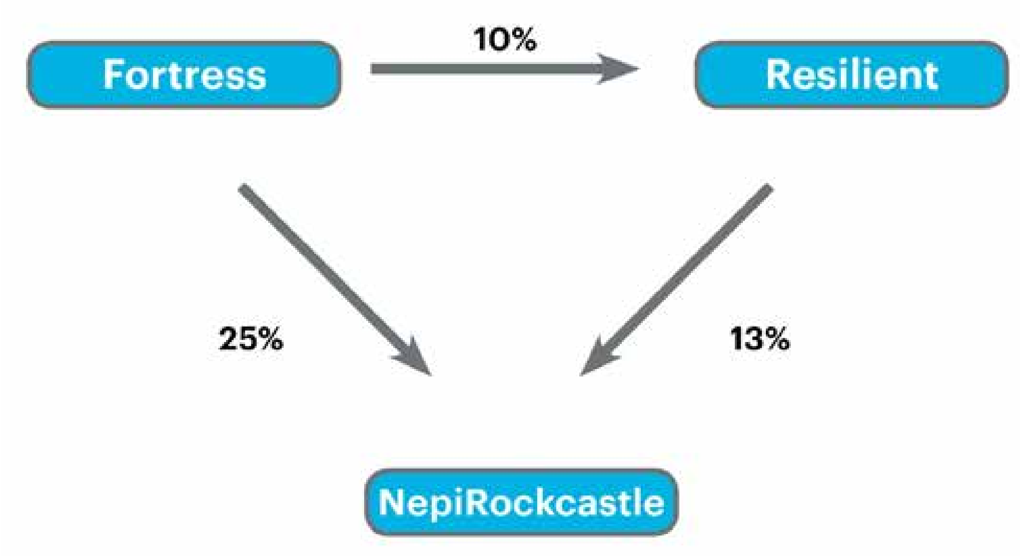
1. Are you prepared to have >20% of your wealth exposed to a single stock?

2. What happens if Naspers suffers a share price shock?

We believe these two questions to be pertinent as investors should be concerned when a high proportion of their savings and wealth is exposed to a few positions in a market that is concentrated and driven by many market agents on the same side of the canoe.

Property

The South African listed property market also exhibits a high level of concentration risk with few stocks representing more than 50% of the indices. The primary example is the Resilient Group of companies, which consist of Resilient, NepiRockcastle and Fortress. These three companies are connected through common management teams and cross-shareholding and as per the latest published annual financial statements, Fortress owns 10% of Resilient and per the NepiRockcastle prospectus, Resilient and Fortress owns 13% and 25% of NepiRockcastle respectively.



Together these three related companies represent close to 40% of the Sapy Index and 35% of the PCAP Index. Similar positions have been taken by certain property unit trusts, as listed in the Table 4.

TABLE 4: EXPOSURE TO RESILIENT STABLE (%)	As of date	NepiRockcastle	Resilient	Fortress	Total
MOMENTUM PROPERTY FUND CLASS A	2017/09/30	16,2	10,1	13,7	40,0
SAPY INDEX	2017/12/29	16,4	10,9	12,1	39,3
SATRIX PROPERTY INDEX FUND	2017/09/30	14,5	10,1	12,1	36,8
PCAP INDEX	2017/12/29	14,5	9,6	10,6	34,6
PRUDENTIAL ENHANCED SA PROPERTY TRACKER	2017/09/30	13,4	8,5	10,4	32,2
CATALYST SA PROPERTY EQUITY FUND	2017/09/30	16,1	9,1	6,6	31,8
STANLIB PROPERTY INCOME FUND	2017/09/30	12,8	11,3	7,6	31,7
DISCOVERY FELXIBLE PROPETY FUND CLASS A	2017/09/30	11,7	9,2	10,2	31,1
EFFICIENT BCI PROPERTY FUND	2017/06/30	10,2	9,8	10,0	30,1
STANLIB MM PROPERTY FUND	2017/09/30	12,3	8,7	6,3	27,3
CORONATION PROPERTY EQUITY FUND	2017/09/30	10,3	6,1	8,9	25,3

The cross-holding effect between these companies further increases the concentration risk for investors as significant value can be destroyed if a major negative event impacts any of the companies within the Resilient stable. An additional risk is the multiple levels of debt due to the cross-holdings and the investment of NepiRockcastle in listed securities, which add another layer of debt. This cumulative effect of multiple levels of debt and the cross-holdings create the potential for significant downside risk and value destruction which will affect the entire South African property market. Again, we are not questioning the quality of these companies, but as recent experience has shown us, having such large exposure creates significant risk to investors' wealth.

At Oasis, we have consistently applied the basic principles of portfolio management and our asset allocation strategy has been developed to ensure that we can deliver stable returns to investors over the long term. This is achieved by ensuring that our portfolios are well diversified in terms of asset class, sector, instrument, geography and currency. Our investment strategy and philosophy has proved its resilience throughout the various economic cycles that have occurred during the last 20 years.

QUIZ ANSWERS

1) How long did the Hundred Years' War last? 116 years
2) In Which country are Panama hats made? Ecuador
3) From which animal do we get cat gut? Sheep and Horses
4) In which month do Russians celebrate the October Revolution? November
5) What is a camel's hair brush made of? Squirrel fur
6) The Canary Islands in the Pacific are named after what animal? Dogs
7) What was King George VI's first name? Albert
8) What colour is a purple finch? Crimson
9) Where are Chinese gooseberries from? New Zealand
10) What is the colour of the black box in a commercial airplane? Orange (of course)