CLUCASGRAY ASSET MANAGEMENT

ClucasGray Asset Management Quarterly Commentary

February 2018

We have fallen upon evil times, and the world has waxed very old and wicked;
Politics are very corrupt;
Children are no longer respectful to their parents."

Inscription on a tablet from Constantinople, 3800 BC

Politics and economics make uneasy bed fellows. As alluded to in the above quote, politicians have been the subject of ridicule and debate since time immemorial – as have inter-generational tensions, it seems! At the extremes, there is no doubt that politics has a material bearing, but in our experience economic fundamentals are mostly dominant.

It has indeed been an eventful few months in South Africa – a new President, new Cabinet, a significantly stronger currency and lower bond yields – coupled with a renewed sense of optimism and confidence in consumers and corporates.

In our September 2017 quarterly, we referred to the Samuel Beckett play, "Waiting for Godot", in describing the national economic mood in South Africa – with the then pending outcomes from rating agency reviews and the ANC elective conference causing angst amongst investors. As things transpired, both events seemed to result in relatively "market friendly" outcomes, with the result that many domestic oriented assets rallied strongly towards the end of the year.

We maintain that in years to come, notwithstanding the frustration that many felt around politics, perception of corruption and low confidence levels in the economy, patient long-term investors will reflect favorably on 2016 and 2017. To list a few of the opportunities we believe investors were presented with:

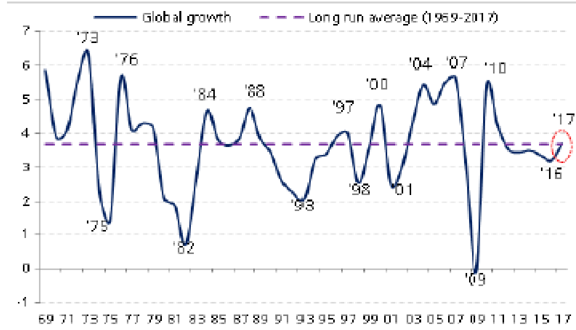
- South African Banks were trading at subdued multiples for some time, with the major banks offering investors attractive opportunities. Most notably, the sell down of Barclays Africa by Barclays Plc at R132 in May 2017, valuing it on a PE of 7x, and dividend yield of 8%,
- Select Retailers, following prolonged stress in the consumer economy were trading at attractive valuations. With the precipitous fall in food inflation, typically the catalyst for improving consumer spend, their prospects for earnings was improving,
- Select industrial companies like Reunert - established brands, with a very strong balance sheet, trading on a 6.5% dividend yield and a very attractive PE multiple,
- Smaller cap food companies, trading for sustained periods of time at "through the cycle" PE multiples of around 8x – these would include Clover and RCL Foods,
- Longer duration Bonds and NCD's trading at real yields of over 5%,
- Bank Preference Shares trading at running dividend yields of over 10%, with the longer-term prospect of capital appreciation from these levels.

Ultimately, history will be the judge as to whether these prove to have been good investments.

Economic Environment

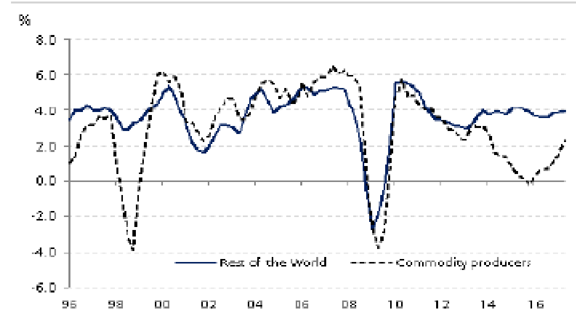
The global economy continues to steadily improve with growth rates heading towards the longer term average of 4%. As evidenced by the below charts, a notable feature of the global recovery has been the recovery of commodity exporter economies, off their recessionary levels of 2015. The current self-reinforcing growth environment remains constructive for commodity demand and has typically been an environment in which commodity currencies perform well.

Figure 3: Global real GDP growth back at its long-run (50y) average



Source: IMF, UBS calculations

Figure 4: But most of the improvement seems to be coming from a narrow set of commodity exporters



Source: World Bank, Haver, UBS calculations (commodity exporters are those countries that have >40% of their exports in metals, food or energy.

We have been encouraged by the steady increase in global inflation, with developed economies' inflation rising towards 2% - this is certainly a more constructive environment for corporates to operate within, compared to the deflationary fears that were pervasive in the years following the global financial crisis. It is also interesting to note that inflation differentials between emerging and developed markets have narrowed materially over the last few decades, as evidenced in the graph below. Given that currencies tend to move in sync with inflation differentials over time, in theory this trend should result in a more benign currency environment.

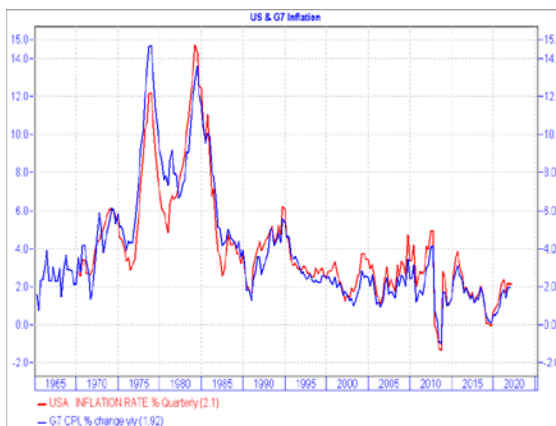


Figure 26: EM inflation (headline % YoY

Source: Haver, UBS calculations

The South African economy has endured a difficult few years. As evidenced by the chart below, this has been the most significant dislocation in SA GDP growth relative to Global growth since the dark days of the late 80's and early 90's. Our view has been that much of the weakness can be explained by the Rand weakness from 2011 to 2015, exacerbated by the commodity downturn of 2015, the drought of 2015/16 in key maize growing areas leading to shortages, and a central bank increasing interest rates to offset these supply side inflationary issues.

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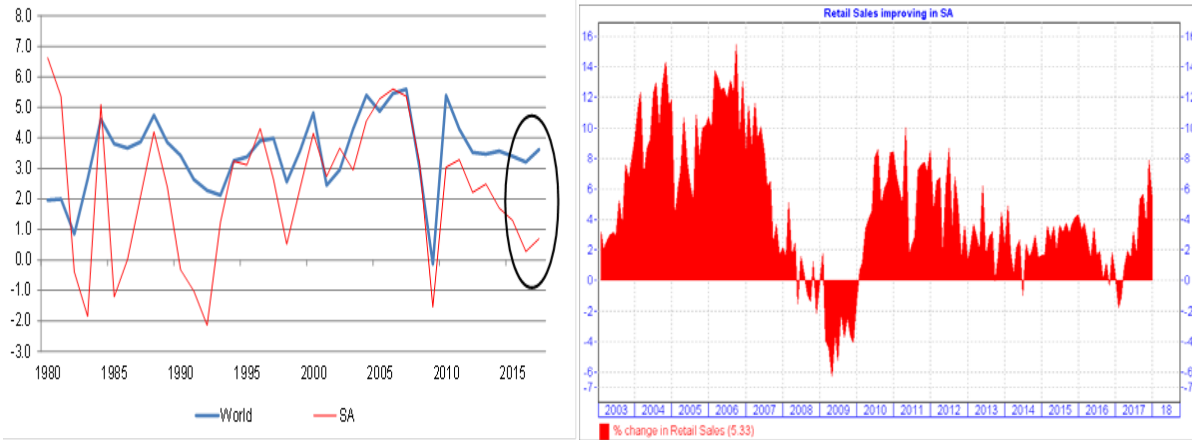
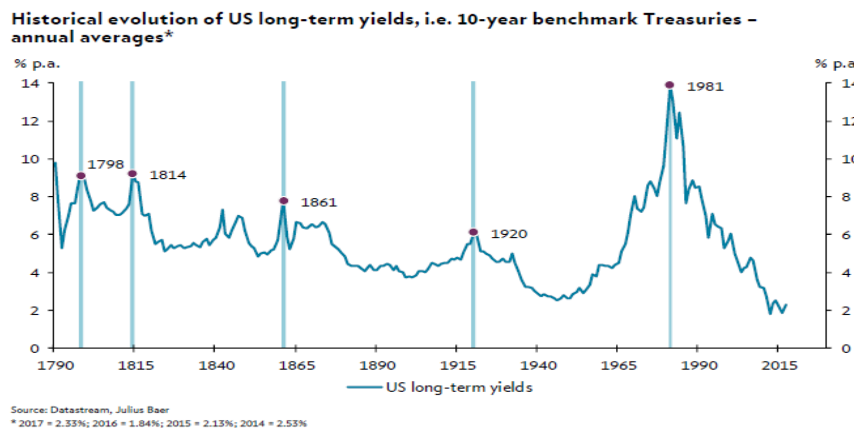
SA GDP has materially lagged Global GDP – early signs of improvement



During 2016 and 2017, we saw a reversal of many of these headwinds, leading to declining inflation, the long overdue start of an interest rate easing cycle, and some encouraging signs of an improving retail sales environment. Recent data releases point to a changing dynamic in South Africa - an improvement in retail sales (chart above), coupled with a positive surprise in GDP growth rates in the final quarter of 2017, demonstrate there are increasingly signs of life in the SA economy. What is interesting about these improvements, is that they have occurred before the euphoria of the ANC Elective conference towards the end of December – perhaps politics and economics are not as closely linked as many surmise?

There have been some seismic developments under way in global markets – the US Dollar has been weakening and Bond yields have been rising – the antithesis of what has been the norm for several years. The US 10 year government bond yield is now nearing 3%, mostly for the constructive reasons mentioned above – economic growth, increasing consumer demand resulting in moderately higher inflation leading to rising bond yields. Nothing sinister, and part of a normal cyclical recovery.

The chart below provides some perspective on bond yields – long run charts are fraught with risk, but nonetheless make for interesting viewing. The recent increase in US Bond Yields in barely evident, but it does highlight the extraordinary tail wind that "bond proxy" type investments, such as defensive industrials and property companies, have enjoyed over the last few decades. Lower yields have enabled investors to justify paying ever increasing multiples for a predictable earnings stream - any sustainable change in yields will have a material bearing on the prospects for many of these investments.



ClucasGray Equity Fund

At ClucasGray Asset Management we leverage off an experienced investment team which adheres to a consistent investment process, enabling us to take advantage of what we deem to be mispriced opportunities across the market cap spectrum. Whilst all investment decisions ultimately require comfort around valuation, the assessment of an investment case includes, amongst other issues, applying an appropriate multiple to a forecast level of earnings.

The reason we make mention of one of our internal screening tools, is that the performance of many domestic focused companies since November has been nothing short of spectacular. Over the course of the last few years we had identified numerous opportunities that were in our assessment mispriced. We were able to make the investment case on valuations, and even with forecasting an unspectacular earnings profile, the expected returns were compelling.

Recent price movements have meant that ratings have moved up considerably, and many of these companies now require an elevated level of earnings to deliver reasonable returns – in many cases the earnings required appear unattainable to us in our forecast period. As a result, we have deemed it appropriate to reduce weightings in select cases. An example of the dramatic movements we have seen, is that one of the retailers we hold, Massmart, has outperformed 2 large global defensive companies, Anheuser and British American Tobacco, by more than 100% since mid-November.

The ClucasGray Equity Fund continues to be exposed to mispriced opportunities, many of which continue to be domestic facing companies. Financials, Retailers, Food Producers and select local industrial companies still make up a material portion of the fund. Whilst the recent rally in many of these has reduced the potential returns from these levels, many remain on undemanding ratings, with an ever improving earnings profile due to the economic backdrop referred to earlier.

Over the last quarter the ClucasGray Equity Fund has delivered 4.9%, against the Swix and the General Equity peer group which both declined over 2%. Over the last 12 months the fund is up 18%, ahead of the Swix, and the peer group which returned less than 10%. The table below shows the Equity Fund returns over various periods against the peer group, and the ranking within the General Equity sector to 28 February 2018.

Annualised Returns	3 months	6 months	1 year	3 years	5 years
CG Equity Fund	4.9%	10.2%	18.0%	6.4%	11.69%
Sector	-2.0%	3.6%	9.6%	3.1%	8.42%
Relative to Sector	6.9%	6.6%	8.4%	3.3%	3.3%
Rank in Sector	18/192	13/186	15/175	7/139	9/106
Fund Quartile	1	1	1	1	1

Ranking Source: Profile Data

ClucasGray Equilibrium Fund

Our commentary over the last few years has frequently referred to our investment approach to managing multi asset funds. The macro economic environment is an important component to the process, and we do spend time formulating our views of the global and domestic environment. However, of far greater importance, is the implication of any environment for asset classes and underlying securities, and the valuations or yields on offer in our investable universe.

From an Equilibrium Fund viewpoint, the last few months saw us make a few changes to the portfolio, on the back of what we deemed to be compelling opportunities. In the build up to the end of 2017, bond yields rose noticeably on the back of concerns around potential rating agencies downgrades and fear of an adverse outcome to the ANC elective conference. Regular readers will be aware that the fund has typically been exposed to shorter duration income assets, preferring instead to take duration in inexpensive property and financial companies. However, with longer duration bonds nearing 5% real yields, we believed the gap between property yields and longer duration bonds was stretched, resulting in us selling down the property holdings, and adding to bonds. Post the “market friendly” outcome of the ANC elective conference, the Rand strengthened, bond yields compressed and prices of financial and retail equities rallied strongly. We continue to balance the portfolio between what we believe are attractive opportunities in local equities,

select bonds and preference shares, with a large weighting in shorter duration income assets providing attractive real yields.

The ClucasGray Equilibrium Fund reached a significant milestone in January 2018 – the 3 year anniversary of its launch in 2015. Investors in the fund have enjoyed a period of very good returns relative to its peers in the Multi Asset High Equity category since inception, and pleasingly delivered on our investment objective of producing industry and inflation beating returns.

Reflecting on the past 3 years, we believe our dynamic approach to asset allocation and security selection, founded on a robust and repeatable investment process, has to date delivered good results. We continue to strive to deliver on our investment promise to clients, by actively taking advantage of mispriced opportunities both at an individual security level, and by actively allocating across asset classes.

The Equilibrium Fund gained over 2% in the last quarter, well ahead of the peer group which declined over 3%. Over the last 12 months, the fund is up over 12% compared to the peer group which gained less than 7%. The table below shows the Equilibrium Fund returns over various periods against the peer group, and the ranking within the SA Multi Asset High Equity sector to 28 February 2018.

Annualised Returns	3 months	6 months	1 year	3 years
CG Equilibrium Fund	2.1%	6.0%	12.1%	7.0%
Sector	-3.2%	1.5%	6.7%	4.1%
Relative to Sector	5.4%	4.4%	5.4%	2.9%
Rank in Sector	5/192	4/188	7/180	6/130
Fund Quartile	1	1	1	1

Ranking Source: Profile Data

For more detail on both the ClucasGray Equity and ClucasGray Equilibrium funds and to view our latest fund fact sheets, please see our new website – **www.cgam.co.za**

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