ClucasGray Asset Management Quarterly Commentary

June 2016

Introduction

Volatility is by no means new to South African investors, and to date 2016 has proved to be no exception. The year began with growing concerns about the prospects for global economic growth, a sell-off in global equity and commodity markets, and a continuation of the Rand weakness which we have experienced over the last 5 years. Many of these macroeconomic concerns did not abate during the second quarter and then on Thursday the 23rd June the UK population voted to end its 43 year membership of the European Union (EU), a process now commonly termed "Brexit".

We do not purport to have any specific expertise on Brexit, and it is very hard to quantify the longer term impact on economic growth at this stage. At a minimum however, there are negative near term consequences of Brexit in terms of a weaker currency, weaker growth and investment and lower consumer confidence in the UK and the Eurozone. The longer term consequences will require a lot more consideration as the terms and conditions of exit become clearer.

The fallout from Brexit is also likely to cause a protracted period of uncertainty and volatility for investment markets and coupled with an environment of slowing growth, this warrants some caution. From a South African perspective, approximately 20% of exports are to the UK and EU combined, and a number of JSE listed companies have direct exposure to the UK – these highlight the potential for some knock on effects. However, we are of the view that these kinds of environments can also present opportunities to patient investors to buy good companies at attractive valuations.

The heightened policy and geopolitical uncertainties around the globe are perhaps best reflected in the fact that the 10 year bond yields for three major economies are now in negative territory; Germany (-0.13%) Switzerland (-0.58%) and Japan (-0.24%). Indeed the US 10 year yield (at 1.44%) is below the levels of the financial crisis.

Market Summary: June 2016

The tables below reflect the percentage change in a number of markets and asset classes:

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Bloomberg Data to:	2016-06-30

DOMESTIC MARKET	Month	YTD	1Y
JSE All Share	-3,13	3,01	0,79
JSE Top 40	-4,17	0,39	-0,36
JSE Resi TR	-3,34	20,54	-19,43
JSE Fini TR	-2,80	-1,03	-7,03
JSE Indi TR	-3,97	-0,29	8,71
Property TR	1,17	9,62	11,04

COMMODITY PRICES	Month	YTD	1Y
Oil (Brent)	-0,02	33,26	-21,87
Platinum	4,59	14,90	-5,05
Iron Ore	13,56	23,50	-12,85

GLOBAL MARKETS (LC)	Month	YTD	1Y
MSCI WORLD INDEX	-1,12	0,66	-2,78
S&P 500	0,26	3,84	3,99
Nasdaq	-2,13	-3,29	-2,89
Euro Stoxx 50	-6,19	-10,22	-13,89
Nikkei	-9,47	-17,34	-21,56
Shanghai	0,45	-17,22	-31,51
FTSE 100	4,72	6,62	3,80
MSCI Emerging	4,00	6,41	-12,05

Exchange Rates	Month	YTD	1Y
ZAR/$	6,25	4,80	-21,02
ZAR/£	13,79	13,99	-2,58
ZAR/€	6,58	2,87	-20,44
ZAR/AUS $	3,45	2,65	-16,96
ZAR/BRL	-5,50	-17,39	-16,92
$/£	8,09	9,67	15,28
$/€	0,23	-2,25	0,37
$/CHF	-1,83	-2,69	4,15

Macro Environment

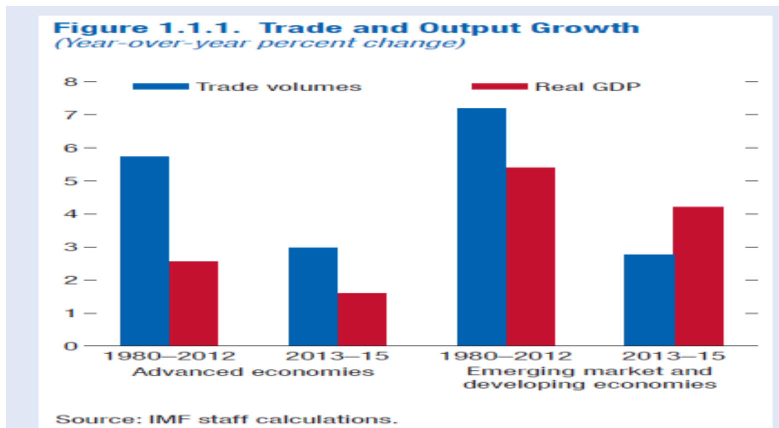
Global growth expectations (pre Brexit) were already reflecting a subdued outlook for the world economy and have moderated by 0.50% from earlier in the year. Recent estimates from the World Bank for global growth are reflected in table below and in aggregate the figures are based on weaker activity in advanced economies (including the US) and a more severe outlook for LATAM, Russia and other commodity exporters.

GDP Forecasts (Source: World Bank	2015	2016	2017
Global	**2,4**	**2,4**	**2,8**
Advanced	**1,8**	**1,7**	**1,9**
US	2,4	1,9	2,2
Euro	1,6	1,6	1,6
Japan	0,6	0,5	0,5
Emerging & Developing	**3,4**	**3,5**	**4,4**
Brazil	-3,8	-4,0	-0,2
Russia	-3,7	-1,2	1,4
India	7,6	7,6	7,7
China	6,9	6,7	6,5
Sub-Saharan Africa	3,0	2,5	3,9
South Africa	1,3	0,6	1,1

Source: Inet

The outlook for the domestic economy remains weak – a low growth environment, inhibited by well documented structural economic issues and the concomitant effects of slower global growth. On the positive side, the prospects for additional rate hikes into a low growth environment appear to be moderating, particularly given some signs of easing inflation (ex food), muted credit extension and lower global GDP.

Slower global growth is also being reflected in world trade growth, measured in absolute volume terms and relative to GDP, which have slowed markedly. Economies and companies will need to make adjustments to a world order of lower trade and investment and the resultant changes in capital flows.



Source: RMB Morgan Stanley

Equity Market Implications

As we have previously commented, it is important to distinguish between the economic outlook and the investment opportunities which the environment presents. An important question from an investment perspective is what the impact of a slowing global growth environment has on company earnings and whether this is appropriately reflected in valuations. As earnings are the key driver of share prices over time, in an environment of slower global growth we remain vigilant on valuations and our preference is for companies with market leading franchises, an ability to deliver real earnings growth through a cycle, and strong management teams.

Given the events of the past 6 months, we think a quote we have frequently used in ClucasGray presentations, by renowned investor Barton Biggs, is particularly apt:

> *"Probably the biggest intellectual problem an investor has to wrestle with is the constant barrage of noise and babble. Noise is extraneous, short term information that is random and basically irrelevant to investment decision making. Babble is the chatter and opinions of the well-meaning, attractive talking heads who abound."*

We live in a news obsessed world, more so now with the ever increasing use of social media platforms, and in South Africa with the continued growth, robustness and credibility of an independent media. We believe it is incumbent upon us as custodians of our clients' investments to maintain perspective, and focus on Investment fundamentals, particularly in times when markets appear to be driven by emotion and sentiment.

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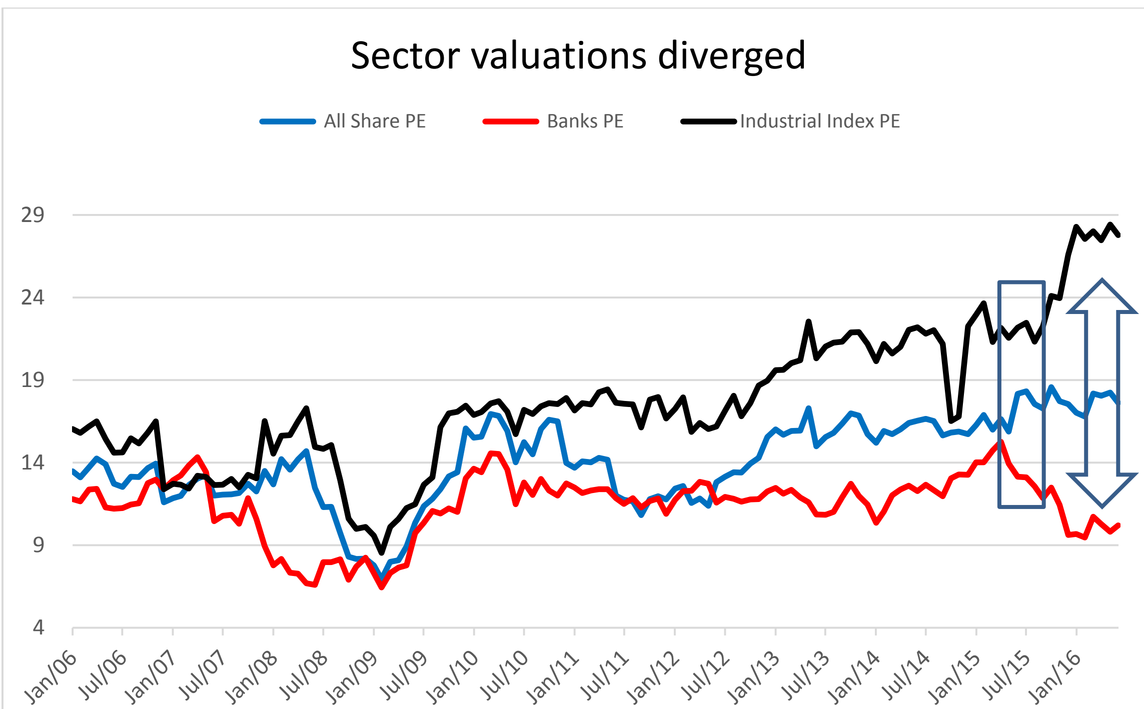
ASSET MANAGEMENT

Investment Market Implications

There are principally two drivers of a company's investment return, namely growth in earnings, and the change in the PE multiple. This simple framework is an important input in the investment process we follow, and a good discipline to highlight the merits of each investment we make on our clients' behalf.

We have previously articulated our concerns over the elevated level of earnings on the JSE. The JSE has become an increasingly global index, due to the successful internationalisation strategy followed by many of our larger companies. A recent analysis showed that 65% of the JSE's Top 40 earnings emanates from foreign currencies - this has certainly shielded investors' in these recent volatile times, where the Rand has depreciated against the US Dollar by 17% per annum over the last 5 years. This has naturally boosted the earnings of the JSE. The risks to earnings are that the Rand stabilises or even strengthens from these oversold levels, and we experience a continuation of slowing global growth trends referred to earlier.

As far as PE multiples are concerned, we believe investors have reason to be cautious. As evidenced by the following chart, the All Share index remains at elevated PE multiples. What is intriguing about the current market, is the dislocation that has occurred with the globally diversified Industrial Index re-rating, and the domestic oriented Banks index de-rating meaningfully. It is seldom that we have witnessed such divergence. Notwithstanding our overarching concerns for select equities, which by virtue of their size have a bearing on the performance of the JSE Indices, we believe there are sufficient opportunities available, which should reward patient investors. These dislocations have provided us with a number of interesting opportunities to make changes to our portfolios.



Portfolio Changes

As mentioned earlier, current valuations, coupled with the potential for muted earnings growth have lead us to adopt a cautious stance to some of the larger Industrial companies on the JSE. However we have continued to take advantage of market volatility to add exposure to those companies which we deem to have been unduly sold off – in many instances these are companies that are exposed to the South African economy, where continued fears around currency weakness and possible rating agency downgrades have created opportunities. In both the ClucasGray Equity Prescient Fund (Equity Fund) and the ClucasGray Equilibrium Prescient Fund (Equilibrium Fund), new entrants to the portfolios include Zeder and Foschini, and we added to our holdings in, amongst others, Old Mutual, Netcare, Banks, Reunert and Holdsport. Within the Equity Fund, we have sold out of Nepi and reduced exposure to select Industrials on the back of valuation concerns.

We have in previous quarters referred to the opportunities we believe are being presented by the South African Banks. From a valuation perspective, the PE ratios and Dividend Yields remain at levels seldom experienced over the last 20 years. The earnings bases of both Barclays Africa and Standard Bank have scarcely grown in real terms over the last 10 years, which mitigates concerns around an elevated earnings base for both companies. Credit extension in South Africa has been benign over the last few years, provisioning levels are strong, and the sector as a whole has very strong capital ratios. We are forecasting steady, if not spectacular, earnings growth, which coupled with current PE multiples and Dividend Yields should reward patient investors.

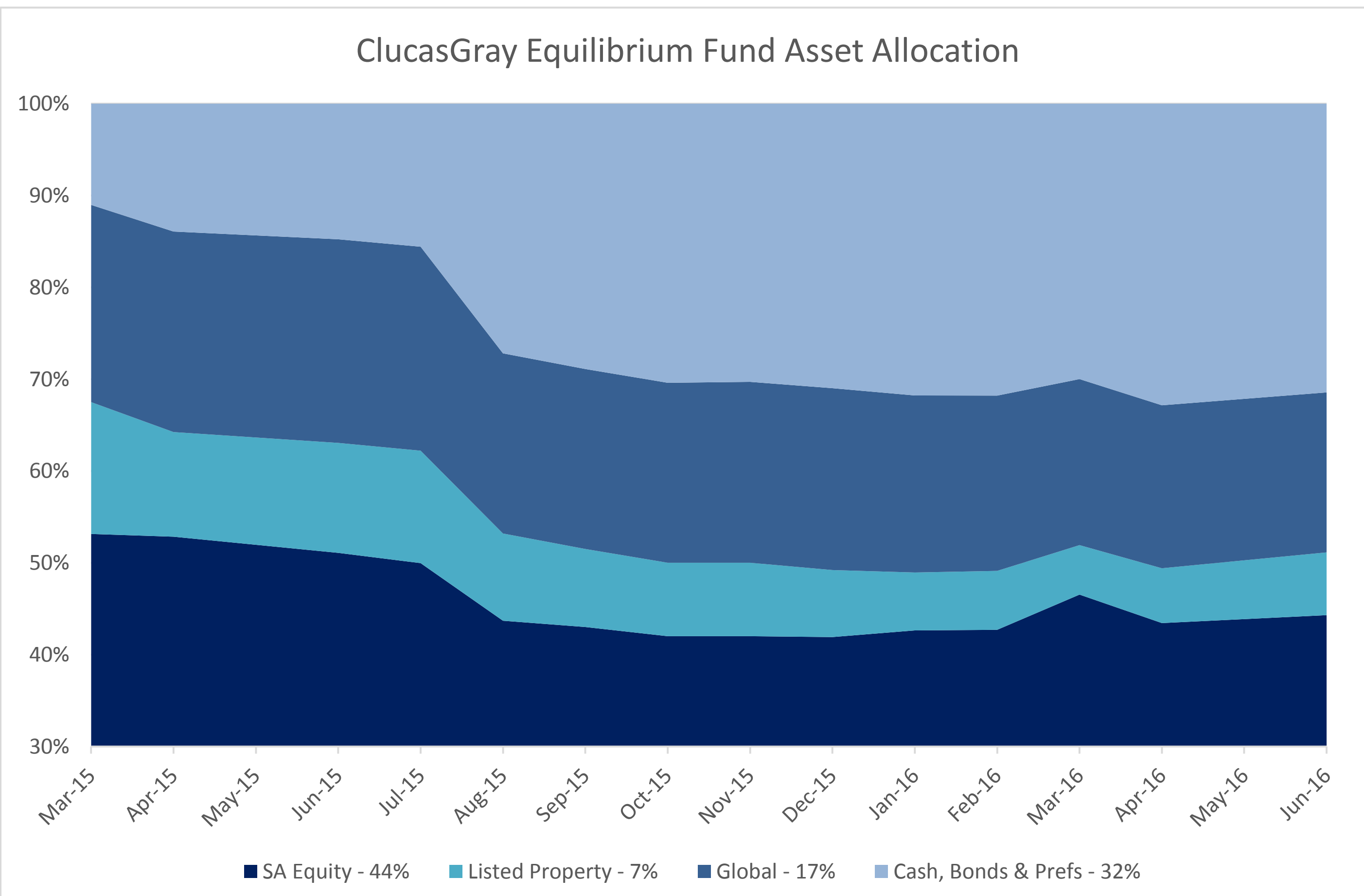
In the Equilibrium Fund, our Multi Asset regulation 28 fund, we continue to adopt a cautious stance to Asset Allocation. Our overall allocation to South African Equities remains low, given concerns expressed earlier. This view has not precluded us from taking advantage of selective opportunities.

The Equilibrium Fund has a 6% weighting to listed Preference shares. During the quarter, both Nedbank and Investec announced their intention to buy back some of their Preference shares, which proved a catalyst for the whole sector to perform strongly in the quarter. We believe the portfolio will be well served by the listed Preference shares. They offer investors running yields of over 10%, and despite their performance in the quarter, continue to trade at a significant discount to their Par value.

During the Rand weakness experienced in May, we once again saw yields on South African Fixed Income instruments rise appreciably. We took advantage of these higher yields, which will provide investors with attractive real returns over the next 3 to 5 years, at relatively low risk.

The offshore weighting of 17% is below prudential limits of 25%. Our rationale for these weightings are firstly that we believe the Rand has been oversold. Secondly, we remain cautious about global equity markets, given a slowing earnings and extended valuations. With Developed Market interest rates close to 0%, income assets globally do not hold much appeal, and with the ability to generate income yields of between 9% and 10% in South Africa, we have chosen to hold higher weightings to domestic income assets.

As illustrated in the chart below, the fund continues to hold over 30% in Cash, Bonds and Preference shares, with the blended yield in the income portfolio being around 9% - we believe this forms an attractive base return in these uncertain times.



Conclusion

The fallout from Brexit is likely to cause a protracted period of uncertainty and volatility; coupled with an environment of slowing growth, this warrants some caution. However, we are of the view that these kinds of environments can also present opportunities to patient investors to buy good companies at attractive valuations.

Our response to managing portfolios in this environment is to remain focused on holding and identifying high quality investments which offer the prospect of real returns for portfolios over the long term. We continue to ask ourselves questions about the appropriate balance between capital growth and capital preservation in considering any investment.

For more detail on both the ClucasGray Equity and ClucasGray Equilibrium Funds, the Fund Fact Sheets are available on our website – www.clucasgray.co.za

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