FOREWORD

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DID YOU KNOW? SHORT SELLING

Short selling, or shorting, is the practice of selling something you do not own to profit from an expected decrease in its price.

The principle is best illustrated by means of a simple example: A trader expects the price of a listed security to decline. She therefore borrows the security from a long-term holder, pledging cash or other assets as collateral for the loan. She sells the security at its current spot price of R100 and receives cash on settlement. Assume she was correct in her assessment and the price declines to R80. She then buys the security in the market and returns it to the long-term holder, expunging her obligation and taking back her collateral with interest. Ignoring trading costs, she has made a R20 profit. Conversely, she would suffer a loss if the price of the security increased and she was compelled to cover her short position.

In financial markets, short selling is often motivated by speculation but is legitimately used to hedge the risk of loss in a security or related securities. Regulators usually ban short selling outright in publicly available investment funds as the maximum loss is theoretically infinite and the practice not widely understood by retail investors. Short selling is often associated with greed, but can provide useful liquidity to investment markets.

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CHINESE STOCK MARKET MOVEMENTS EXPLAINED

Chinese manufacturing and investment indicators have been contracting for some time as the world's second largest economy struggles to reduce its reliance on fixed investment growth. A stock market rout in the second quarter has put the country's economic and financial performance in the spotlight. BRIAN ARCESE looks at the development of the Shanghai bourse and its boom-bust cycle this year.

Relative to developed and other emerging markets, Chinese economic growth has been unrivalled for the last two decades. The growth rate after the global financial crisis has been equally impressive, averaging almost 8% per year since 2011. Fixed asset investment growth underpinning the urbanisation of China's massive rural population has been the driving force behind the growth.

Commodities entered a decade-long bull market as China became the major buyer of most industrial commodities. Cheap, abundant labour infiltrated the world through "Made in China" labels, to the detriment of manufacturers elsewhere in the world. Despite, or perhaps because of, its central planning and lack of free market policies, China developed to overtake Japan as the world's second largest economy.

The Shanghai Stock Exchange, one of two on the mainland, is among the top 10 in the world by market capitalisation. However, due to restrictive capital controls it is not fully accessible to foreign investors. In late 2014, the Shanghai–Hong Kong Stock Connect was introduced to link these two giant Asian bourses, allowing investors in each market to trade shares of the other using their local brokers and settlement houses.

The implementation of this cross-boundary channel was the catalyst for rising share prices on the Shanghai exchange, which is dominated by almost 100 million retail investors. Amid accommodative monetary policy and the urging of state-controlled media, investors embarked on a credit-fuelled stock market binge. In essence, investors used borrowed money to buy listed shares and to invest in initial public offerings (IPOs) at heavily inflated prices. There are many anecdotes of taxi drivers and low income earners with hundreds of thousands of renminbi invested in listed shares, mostly with money they did not have.

This worked well for some time, as Chinese stocks made a 150% run from July 2014 to their peak on 12 June 2015. A thriving share market was seen as an endorsement of President Xi Jingping's economic policy to steer the country away from bank lending and to develop a diversified financial sector. Accordingly, the state often encouraged investment while denying the existence of a stock market bubble despite share prices expanding significantly faster than economic and earnings growth.

At the time of writing, the index has fallen 34% from its peak, with significant intra-period volatility. The cause of the collapse is uncertain, but the catalyst may be MSCI's announcement that Chinese mainland shares would not qualify for inclusion in the main MSCI Emerging Market Index. As prices fell, investors faced margin calls on their heavily geared positions. Those with insufficient cash reserves were forced to sell shares in the market, causing market panic.

The market rout has been an undeniable embarrassment for the Chinese authorities, which intervened in an attempt to reflate the bubble it helped to create. Measures adopted included a trading halt, suspension of IPOs, relaxation of rules on margin loans and collateral, sales bans on major shareholders, prohibitions on short selling (see *Did You Know?*) in certain circumstances and the provision of cash to brokerages to buy shares. Some or all of these measures appear to have stabilised the market. However, the longer term damage caused by government intervention is unknown.

UNDERSTANDING **INVESTMENT RISK**

Regulators have increasingly focused on the protection of retail investors in financial products during the last decade. Managers of collective investment scheme portfolios must now disclose a risk indicator on marketing material of investment portfolios. Industry practice, in our view incorrectly, promotes a system that classifies risk according to equity weighting. Thus, portfolios with a low allocation to share markets are "low risk," while portfolios with a higher equity allocation are classified as "high risk." WILLIAM FRASER unpacks investment risk.

Such a risk classification system can only be justified by equating short-term variability of returns – volatility – with investment risk. It is common knowledge that share market volatility, when measured over short time horizons, is greater than the volatility of asset classes such as cash or bonds where interest or coupon payments comprise a greater percentage of total returns. This leads to the incorrect and financially damaging assumption that portfolios with greater short-term variability in returns are riskier investment propositions.

This system ignores the investment objective of the portfolio, the expected duration of the investment, the investment philosophy of the investment managers and their past success in achieving the objective. Many of these more important measures of investment risk require more in-depth knowledge of investment managers and their track records. This requires significant management time and due diligence. The resultant risk assessments, however, have very little to do with equity weighting in portfolios.

Foord has always classified investment risk as the risk of permanent loss of capital. Increased volatility does not cause permanent loss of capital and therefore is not an appropriate measure of investment risk. Examples of permanent loss of capital include corporate failures leading to bankruptcy, massively dilutive rights issues (companies issuing new shares), sovereign and corporate bond defaults, bank failures or the purchase of investments (shares, bonds, property or commodities) at excessive valuations where the earnings never materialise and share prices subsequently fall.

Investment risk can be significantly reduced by avoiding investments with an elevated probability of permanent capital impairment. This concept of investment risk applies to all investments, not only share investments. Accordingly, equating investment risk to equity weighting is misconceived and detrimental to the long-term savings objectives of investors.

This brings us to current market conditions. Those investors who closely follow markets have undoubtedly noticed a marked increase in the daily movements of individual share prices and market indices. This is very different from the prior post GFC[1] period where share prices increased reasonably smoothly.

> FOORD HAS ALWAYS CLASSIFIED INVESTMENT RISK AS THE RISK OF PERMANENT LOSS OF CAPITAL.

The longer a certain trend is intact, the more certain we can be of a change in direction of share prices. Near zero percent interest rates and excess global liquidity have caused a period of stable but rising share prices. The paucity of attractive investment opportunities in other asset classes has constrained investors to equities, further elevating the market rating.

As we approach the end of near zero percent US interest rates, some investors are choosing to exit share markets. Less resilient shareholders typically sell at any price when volatility levels become too uncomfortable. They may question their actions and change their decision a number of times. This leads to prices rising and falling, with greater undulations between decisions, and volatility increases. During these periods, investors with longer time horizons and greater tolerance for volatility get the opportunity to purchase great companies at much reduced prices.

This increased volatility is not necessarily a measure of increased risk of loss, but an indication of the increasing uncertainty of stock market investors. The continuous postponement of an interest rate increase in the United States is mainly to blame for this uncertainty. Market participants have been expecting an interest rate rise this year and this information has been priced into share markets. Recent developments and September's decision not to raise rates have caused market participants to doubt their conviction.

The volatility issue aside, it should also be noted that the rise in market multiples and the poor investment climate in a growing number of sectors is simultaneously increasing investment risk (that is, the risk of permanent loss of capital). So we are experiencing elevated investment risk at the same time as elevated volatility. Distinguishing between risk and opportunity takes both skill and experience, supported by rigorous investment research.

Thankfully, the portfolio managers at Foord have investment experience ranging from 10 years to 35 years and most have experienced at least three full investment cycles. The portfolio managers' experience, the rigour of the research supporting the purchase of quality companies, the diversification of the aggregate portfolio, the conviction behind the portfolio construction and, most importantly, the courage to remain invested for the long term are the safety mechanisms provided to investors in professionally-managed portfolios.

[1] The Global Financial Crisis of 2008 / 2009

DON'T CHOP AND CHANGE

The powerful emotions of greed and fear mean that it is simply human nature to chase the best returns. As a result, investors often fall into the trap of disinvesting from an underperforming fund to invest in one that outperformed over the same period. Studies abound on the folly of such an investment strategy. For example, a seminal US study[1] showed that frequent trading eroded investor returns by up to 2.7% per annum. ADELE JANKOWITZ puts the Foord Equity Fund to the test.

Given the investability of its benchmark, the FTSE/JSE All Share Index (ALSI), and the fund's long, 13-year history, the Foord Equity Fund is ripe for testing the effects of a "chop and change" investment strategy. Our analysis tested an alternative investment in the ALSI (investors are able to invest in any number of financial products that mirror the return of the ALSI). In these analyses, investors were assumed to have considered the return in the immediately preceding period and then invested in either the fund or the benchmark for the subsequent period depending on which had the higher *ex ante* return.

Several scenarios were assessed. First, a monthly strategy was followed in which the fund's return at the end of the month was compared with that of the benchmark. The investor was assumed to have "chopped and changed" based on an analysis of returns of the fund compared to the ALSI over the month. Next, we analysed the effects of applying such a trading strategy to longer periods, evaluating both one- and three-year periods.

The results were not unexpected but they did expose the extent of the foolhardiness of a "chop and change" trading strategy. Applying the monthly strategy to the Foord Equity Fund resulted in an annualised average return over the 13-year period of 18.1%, which was only marginally better than the ALSI's 17.3% and well short of the fund's actual 20.5% per annum return. Clearly, the trading strategy would have cost an investor 2.4% per annum for 13 years (excluding any costs associated with buying an index tracker fund).

> INVESTORS DO BEST TO MAKE A WELL-CONSIDERED DECISION AT THE INCEPTION OF THE INVESTMENT AND TO PERSIST WITH THAT DECISION.

Using a 12-month return when implementing the trading strategy, the Foord Equity Fund still returns an average of almost 1.0% per annum more than the strategy. Even more telling, simply holding the fund would have outperformed the trading strategy in 87% of rolling 12-month periods. Over a three-year period, these results are amplified: the fund exceeds the strategy's return by a little more than 1.0% per annum, but the fund outperforms the strategy in 98.6% of rolling 36-month periods. These are not odds that any rational investor should be taking.

The message is clear: investors do best to make a well-considered decision at the inception of the investment and to persist with that decision. This notion is vindicated by reams of academic literature dealing with the effects of emotion on investment choices, and, indeed, this simple empirical analysis.

As has been noted on many occasions, successful investing is not about timing the markets. It's about spending time in the markets.

[1]Source: Barber & Odean, "Boys Will Be Boys: Gender, Overconfidence, and Common Stock Investment", Quarterly Journal of Economics, 2001, pp 261 – 292

- FOORD CONSERVATIVE FUND
- FOORD BALANCED FUND
- FOORD FLEXIBLE FUND OF FUNDS
- FOORD EQUITY FUND
- FOORD INTERNATIONAL FEEDER FUND
- FOORD GLOBAL EQUITY FEEDER FUND

IT'S A FACT(SHEET)

Foord recently refreshed all fund fact sheets to reflect new legislative requirements for minimum disclosure documents. We took the opportunity to include valuable fund information in a format that we believe is simple and easy to understand. These fact sheets are comprehensive and provide detailed information on the funds in which you are invested. We encourage you to read these fact sheets regularly.

TAX FREE INVESTMENT

Earlier this year Foord introduced tax free investment accounts for the Foord Balanced and Equity Funds. This tax free offering has now been extended to include the Foord Flexible Fund.

UNDER CONSTRUCTION

Those investors who have recently visited the Foord offices will have noticed the ongoing renovation works. The renovation is unsurprisingly taking longer than originally expected but we hope to welcome you to our new space soon.

FOREWORD ONLINE SOON

Foreword is going digital and will soon be available online with articles posted on Foord's website. We will continue to print *Foreword*, however, please let us know if you would prefer to receive it in the new digital format.

MARKETS IN A NUTSHELL

INTERNATIONAL

EQUITIES

Global bourses (-12.9%) suffered one of their worst quarters since the global financial crisis — after emerging markets (-17.8%) plunged following a rout on the Shanghai Stock Exchange and a string of negative news flow out of China

BONDS

Developed market bond yields fell from already depressed levels on renewed demand for safe haven assets — sharply lower commodity prices are entrenching disinflationary trends as the slowing Chinese economy stokes global growth fears

CURRENCIES

The Chinese renminbi devalued after authorities permitted an element of market determination in the currency value rather than an outright "currency peg" — commodity export currencies followed metals and oil prices lower with some currencies reaching all-time lows

COMMODITIES

The fall in commodity prices resumed in earnest, with oil and platinum the big losers — weak industrial demand, especially from China, excess supply and renewed commodity ETF liquidations precipitated a vicious downward price spiral

ECONOMY

Improving US consumption is increasingly contributing to GDP growth in the world's largest economy — starkly contrasting with major developing economies where low commodity prices and poor demand translate into sub-par growth

MONETARY AND FISCAL POLICY

Concerns about global growth and uncomfortably low inflation ultimately swayed the FED to stay its hand in finally raising rates — consensus expectations still favour a December increase despite Yellen's fairly dovish outlook statement

SOUTH AFRICA

EQUITIES

The FTSE/JSE All Share Index (-2.1% in ZAR, -4.0% in US$) outperformed, buoyed by the dual-listed industrial rand hedge shares SABMiller, Richemont, British American Tobacco and Steinhoff — but resource shares fell 17.9%

BONDS

SA bonds (+1.1%) outperformed equities despite 10-year yields drifting higher – the effects of a much weaker ZAR and continued foreign selling of SA bonds offsetting the MPC's "hold" decision and unexpectedly low inflation print

CURRENCIES

Softer commodity prices and emerging market malaise caused significant rand depreciation (-12.0% vs dollar) — the trade account has responded, significantly reducing SA's current account deficit and moderating the material risk of further near-term depreciation

ECONOMY

The SA economy (-1.3%) contracted in the second quarter — underlying household consumption expenditure trends imply that SA consumers are under significant stress, notwithstanding much lower fuel prices

MONETARY AND FISCAL POLICY

SARB increased interest rates to 6.0% in July but subsequently took a more dovish stance — weighing the risk to GDP growth against prospects for higher inflation stemming from rand depreciation

FUND OBJECTIVE

FOORD CONSERVATIVE FUND

Inception date: 2 January 2014

The fund seeks to provide investors with a net-of-fee return of 4% per annum above the annual change in the South African Consumer Price Index, measured over rolling three-year periods. The portfolio is managed to comply with the statutory limits set for retirement funds in South Africa (Regulation 28 to the Pension Funds Act). The fund is appropriate for conservative investors who are close to, or typically in, retirement and whose time horizon does not exceed three to five years.

	Since Inception %	3 Years %	1 Year %	3 Months %
Foord*	**7.2**	-	6.4	-0.1
Benchmark	**10.1**	-	9.1	2.8

Benchmark: CPI + 4% per annum, which is applied daily by using the most recently available inflation data and accordingly will be lagged on average by 5 to 6 weeks.

FOORD BALANCED FUND

Inception date: 1 September 2002

The steady growth of income and capital, as well as the preservation of real capital (being capital adjusted for the effects of inflation). The fund is managed to comply with the prudential investment limits set for retirement funds in South Africa. The fund is suitable for pension funds, pension fund members and holders of contractual savings products.

	Since Inception %	3 Years %	1 Year %	3 Months %
Foord*	**16.4**	13.9	6.6	-1.1
Benchmark	**14.0**	12.5	3.9	-0.6

Benchmark: The market value weighted average total return of the South African Multi Asset High Equity unit trust sector, excluding Foord Balanced Fund.

FOORD FLEXIBLE FUND OF FUNDS

Inception date: 1 April 2008

To provide investors with real returns exceeding 5% per annum, measured over rolling three-year periods. The fund will exploit the benefits of global diversification in a portfolio that continually reflects Foord Asset Management's prevailing view on all available asset classes, both in South Africa and abroad. The fund is suitable for investors with a moderate risk profile who require long-term inflation beating total returns.

	Since Inception %	3 Years %	1 Year %	3 Months %
Foord*	**14.5**	18.4	8.5	-0.8
Benchmark	**11.4**	11.1	10.1	3.0

Benchmark: CPI + 5% per annum, which is applied daily by using the most recently available inflation data and accordingly will be lagged on average by 5 to 6 weeks.

FOORD EQUITY FUND

Inception date: 1 September 2002

To earn a higher total rate of return than that of the South African equity market, as represented by the return of the FTSE/JSE All Share Index including income, without assuming greater risk. The fund is suitable for investors who require maximum long-term capital growth and who are able to withstand investment volatility in the short to medium term.

	Since Inception %	3 Years %	1 Year %	3 Months %
Foord*	**19.8**	17.2	4.7	-4.4
Benchmark	**16.8**	15.4	4.8	-2.1

Benchmark: Total return of the FTSE/JSE All Share Index

FOORD INTERNATIONAL FEEDER FUND

Inception date: 1 March 2006

To provide exposure to a portfolio of international assets including equities, fixed interest, commodities and cash. This is achieved through direct investment into the Foord International Fund, which aims to produce an annualised return over time in excess of 10% in US dollars, thereby expecting to outperform world equity indices. The fund is suitable for South African investors who seek to diversify their portfolios offshore and to hedge against rand depreciation.

	Since Inception %	3 Years %	1 Year %	3 Months %
Foord*	**13.2**	22.1	17.7	4.1
Benchmark	**11.0**	19.9	13.3	5.6

Benchmark: The ZAR equivalent of 10% per annum in US dollars

FOORD GLOBAL EQUITY FEEDER FUND

Inception date: 2 May 2014

To provide investors with exposure to a diversified mix of global equity and equity-related securities. This is achieved through direct investment into the Foord Global Equity Fund, which aims to produce a higher total rate of return than the MSCI All Country World Index, without assuming greater risk.

	Since Inception %	3 Years %	1 Year %	3 Months %
Foord*	**8.3**	-	5.4	-3.1
Benchmark	**16.9**	-	14.4	3.1

Benchmark: ZAR equivalent of the MSCI All Country World Equity Index.

NOTE: Investment returns for periods greater than one year are annualised

* Class R, Net of fees and expenses

PLEASE REFER TO THE FACT SHEETS CARRIED ON WWW.FOORD.CO.ZA FOR MORE DETAILED INFORMATION.