# FOREWORD

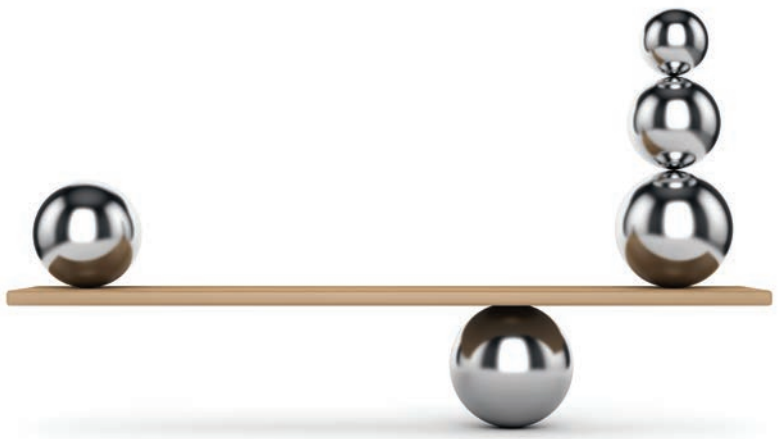
ISSUE 49 1st QUARTER 2019

## DID YOU KNOW? LEVERAGE

In physics, leverage refers to the mechanics of converting a small input force into a much larger output force. The financial world uses the term to describe the effect of borrowed capital on investment returns.

Financial leverage is often referred to as "gearing," another word appropriated from physics. It describes the ability of an investor to use borrowed money to amplify the return on investment. This only works if the profit on the investment is greater than the cost of the debt.

Leverage also works in the opposite direction — if the investment is not profitable, losses are amplified, too. The use of leverage therefore alters the risk reward profile of an investment and should be used judiciously.





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# ATTRITIONAL BEAR MARKETS

**Are we in a bear market and do we expect a V-shaped or U-shaped recovery? How long will it persist? PAUL CLUER takes a closer look at the current landscape and explains the shape of what's to come.**

We've written in these pages about the extra-long duration of the current global expansion, which is now undoubtedly in its late stages. Share markets rolled over in 2018 in anticipation of recession as US interest rates looked set to rise further, albeit at a slower pace. The bulls were in retreat.

Yet US Federal Reserve Chair Jerome Powell stood firm on rising rates and quantitative tightening, withstanding an angry Twitter onslaught from President Trump. But in a surprising January policy U-turn after a brief brush with systemic risk, Powell turned dovish on both aspects of monetary policy after markets had fallen 20%.

The Powell Put was at last in play (see *Foreword* Issue 45, 1st Quarter 2018, for an explanation of the Bernanke Put). Markets consequently rallied, recouping all of 2018's losses. It appears that the bears are now at bay.

But are they? The accepted definition of a bear market is a 20% decline from peak to trough. Bear markets can be V-shaped (quick recovery) or U-shaped (more sluggish recovery). But recover they do.

While the Powell Put stemmed further market losses, it simply deferred the inevitable. A global economic recession this year will confirm the bear market. But absent a global recession, stock markets still face headwinds of slowing growth and more distant interest rate increases. We believe we're into the realms of a slow-burning, attritional bear market.

Because developed market interest rates will now take longer to normalise, market valuations will have better support. The result is that quality companies are fully priced. But any adverse, stock-specific news results in panicked selling so typical of bear markets.

Attritional bear markets therefore act at stock level. The V-shapes and U-shapes will be evident in price graphs of individual companies rather than the broader index of stocks.

South Africa has its own economic challenges but is still much more open to the world than it used to be. Commodities are no longer the main economic driver. The country will therefore not experience the types of commodity-shock bear markets of its past. But it is in an attritional bear phase.

Last year, several quality JSE-listed businesses were heavily punished for not unusual operating or financial headwinds. The market's reaction was brutal and likely overdone with no discrimination between instances of permanent capital destruction and those where the headwinds are temporary. Leveraged (see *Did You Know?*) companies that are still benefiting from low interest rates weren't spared.

Recent examples are Richemont, British American Tobacco and Anheuser-Busch Inbev, which all de-rated in 2018. These stocks are amongst the best performers in 2019 as the market reassesses leveraged companies more favourably, given the Fed's policy U-turn.

This is a tailwind to Foord's portfolios where quality companies capitalising on cheap leverage was a specific theme. We believe that Aspen falls into the same category.

Attritional bear markets provide similar opportunities to long-term investors to market-wide bear markets. **Patience, diversification and generous liquidity must be the order of the day.** In this environment, investment returns will come from earnings and stock-picking, not from rising markets.

# FOUNDATIONS FOR **LONG-TERM INVESTMENT GROWTH**

BRIAN ARCESE Portfolio Manager

**As we near the end of possibly the longest equity bull market in history, major US markets suffered their worst December since 1931. Investors who re-positioned portfolios for this correction were wrongfooted when markets recovered sharply this year (the major US indices staged their best annual start since 1987). BRIAN ARCESE explains the critieria required to weather volatile markets.**

Professional, fundamental investors exploit increased volatility and market dislocations to buy high quality companies at attractive valuations. But volatility can alarm retail investors. The unending flow of financial headlines — rising populism, Brexit/no Brexit, US/China trade wars, increased geopolitical tensions — can leave retail investors fearful and ready to sell. Unfortunately, retail investors too often divest at the market cycle's bottom, locking in much of the downside while missing a later market rebound.

So how can investors weather volatile markets? Six fundamental portfolio construction practices help to withstand volatile markets and grow investment portfolios. These pillars focus on identifying high-quality, cash generative companies with sustainable earnings growth prospects and superior management teams. Because share prices track earnings growth over time, these criteria provide a solid foundation for long-term investment growth.

***Focus on earnings per share.*** The earnings per share (EPS) ratio reflects the company's profits on a per share basis. Because dividends are declared out of earnings, EPS indicates the company's dividend potential. Over time, dividends account for a significant portion of the total shareholder returns. A consistently growing EPS is therefore a good primary indicator of a firm's soundness and stability.

***Sustainable, competitive advantages matter.*** Quality businesses enjoy a sustainable competitive advantage and strong franchise value. They exhibit steady earnings growth and a durable business model. An obsessive focus on value proposition and cost control allows such companies to generate higher revenue at greater profitability than peers, leading to correspondingly better return on capital.

***Strong balance sheets and cash generation support survival and expansion.*** Companies that generate strong, free cash flows, the lifeblood of any business, to internally fund growth are attractive. In contrast, poor management teams don't appreciate the value of cash generation until they need it but don't have it. Strong balance sheets and cash flow generation are essential in lean times, for ongoing investment, business expansion and for paying dividends.

***There is no substitute for excellent management.*** The competence and quality of the management team are paramount to the company's culture, strategy and success. Even companies with excellent products can be mismanaged. A winning management team displays superior capital allocation skills and fiscal discipline by not overinvesting during periods of economic strength or underinvesting during periods of economic weakness. The team's economic interests are typically well aligned with those of shareholders.

> Retail investors too often divest at the market cycle's bottom.

***Valuation — buy at the right price.*** Superior returns come from buying good companies at reasonable valuations. A company's valuation can be compared to peers and to the market using the price-to-earnings (PE) ratio. The PE is a simple valuation metric calculated by dividing a share's price by its EPS. While high quality firms do not typically trade at discounted PEs, it is nevertheless important to not overpay for an investment. An overpriced asset can materially reduce long-term returns.

***Exit a losing investment quickly.*** All investors, including professionals, make mistakes. But successful investors usually admit their mistakes early, exit those positions and replace them with even better prospects. Don't panic if a share you own declines. Instead, review these investment criteria to assess if something has materially changed — the entry of a new competitor may have eroded the firm's competitive advantage or a management team may have made an atypically insensible decision that does not create long-term value. In these instances, investors should consider divesting, even if it is at a loss, to seek better investment opportunities to redeploy capital.

## THE ROLE OF **THE TRUSTEE**

**Unit trust schemes, such as Foord Unit Trusts, are established by a deed of trust for the benefit of investors. As FAIEKA SLEMMING explains, the deed is between the manager and an independent trustee that provides a fiduciary oversight role.**

The duties of the trustee are established in law and include ensuring that the scheme is managed and administered in compliance with the law and deed. The trustee must report directly to the regulator if it becomes aware of any irregularity or undesirable practice in the unit trust scheme.

Investments are registered in the name of the trustee and must, by law, be kept totally separate from the business assets of the manager and the trustee. In practice, this is done using the trustee's nominee company.

A trustee, although appointed by the unit trust manager, must be approved by the regulator. Only entities with adequate capital and operational ability may act as trustees. The trustee of the Foord Unit Trust Scheme is Rand Merchant Bank, a division of FirstRand Bank Limited.

# DEMOGRAPHICS
## IS DESTINY*


NANCY HOSSACK Equity Analyst

**As long-term investors, we spend a lot of time thinking about structural changes happening in the world that will change the economic value chain. As NANCY HOSSACK explains, these studies are a crucial part of the roadmap.**

We study dozens of long-term trends such as the impact of digital interconnectivity or the rise of electric (and even driverless) motor vehicles. We look for parts of the global economy likely to be the natural winners over time and avoid those where headwinds may build. We seek the best structural growth opportunities to underpin the portfolios' inflation-beating returns.

We pay particularly close attention to demographic trends, which is the statistical study of populations and how they change. We know what the population profile is today and that each day everyone gets a day older, some people die and new people are born. The expected population profile through time is therefore predictable and reliable.

Demographics matter for three primary reasons:

1. Economic growth depends on the size of the working age population and productivity growth;
2. People are natural buyers of financial assets in their working years (accumulating capital) and natural sellers in retirement (pension income), which affects asset prices; and
3. Consumer preferences also change — a 20-year old today has different spending priorities than a 20-year old of 25 years ago.

We know that the world population is ageing. The baby boomer generation (post World War II births) is retiring in large numbers — 10 thousand people a day retire in the US alone.

The healthcare sector should benefit from this demographic shift. For example, an 80-year old spends twice as much on healthcare as a 60-year old, who spends twice as much as a 40-year old.

Healthcare spending as a percentage of the US economy is indeed rising as the population ages. Our portfolios hold several companies well positioned to benefit from this long-term theme. CVS Health, Roche and Johnson & Johnson are some examples.

Another related demographic shift is the rise of the Asian middle class, where populations on average are much younger. The Asian share of the global middle class will go from one third in 2009 to two thirds by 2030.

This rapidly growing group of consumers will also have rising incomes as they progress through the working-age cycle. The portfolios own companies such as the People's Insurance Company of China, JD.Com and Kasikornbank in Thailand that will benefit from the structural growth in Asian consumer spending over the coming decades.

While demographic trends are critical to the investment process at Foord, all Foord portfolios remain well balanced across diversified drivers of return, making sure that no single theme or investment idea dominates the outcome.

**August Comte, 19th century philosopher*

# BOOK DASH

**Foord has long been a significant supporter of South African educational initiatives. CHRISTINA CASTLE introduces Book Dash, a relatively new association that aims to give every South African child 100 books to call their own. How they go about this challenge is creative, inspiring and the reason Foord just had to get involved.**

Founded by a dynamic team of passionate young minds, Book Dash aims to flood South Africa with storybooks for very young children to address the nation's critical literacy crisis. The innovative Book Dash creation model harnesses creative volunteers to make high-quality African storybooks over a 12-hour sprint.

> The number of books in the home has been shown to be the most powerful predictor of a child's future academic success, no matter where a child comes from or their socio-economic status. (Evan et al 2010)

And a book dash it literally is. Twice a year, 10 teams comprising writers, illustrators and graphic designers come together to create a collection of relevant stories for a particular age group in one day, following the innovative Book Dash process. The books are then translated, printed and distributed directly to children and parents across South Africa through partner organisations.

Since 2014, Book Dash has created 117 original, engaging African picture books and printed and distributed 430 000 copies to children across the country. Their immediate goal is to reach a million books distributed by the end of 2020.

For more information, to see the books or to get involved in this wonderful initiative, visit **www.bookdash.org.**

# MARKETS IN A NUTSHELL

## WORLD / SOUTH AFRICA

### EQUITIES

**World:** Global equity markets rallied strongly after the Q4 2018 sell-off — US markets enjoyed their best first quarter return in 20 years

**South Africa:** The FTSE/JSE Capped All Share Index also rose, led higher by resource counters on commodity strength and rand weakness — but industrial and financial counters declined on economic headwinds

### BONDS

**World:** US 10-year bond yields fell sharply as investors reacted to the US Federal Reserve's policy U-turn — the US yield curve briefly inverted as bond prices rallied

**South Africa:** SA government bond yields tracked global yields lower amid renewed risk appetite — the SA All Bond Index posted positive returns

### CURRENCIES

**World:** The US dollar weakened after the Fed's U-turn — but resumed its gains latterly

**South Africa:** The rand weakened on US dollar strength — but recovered at quarter end as Moody's delayed its credit rating review

### COMMODITIES

The oil price rose on supply disruptions from Venezuela, further Saudi-led OPEC production cuts and a surprise US stockpile decline — while iron ore surged on severe supply disruptions following a Vale tailings dam failure in Brazil

### ECONOMY

**World:** Despite continued US economic strength, the broader macroeconomic environment deteriorated — European economic weakness and fears of slower Chinese growth compound late cycle growth concerns

**South Africa:** Economic growth was marginally positive, but stressed as shown by Mboweni's downbeat budget and the return of erratic Eskom load shedding — the looming elections make meaningful economic reforms improbable in the near term

### MONETARY AND FISCAL POLICY

**World:** The Fed's new dovish policy stance signals concern for global economic health — it announced that no further interest rate hikes are likely in 2019 and that it will slow the pace of quantitative easing withdrawal

**South Africa:** SARB revised down its 2019 forecast for economic growth and inflation, but kept interest rates steady — high real yields are an attractive investment opportunity but they are too restrictive, raising the possibility of a repo rate reduction later this year

# FUND RANGE

## BEST INVESTMENT VIEW FUNDS

### FOORD FLEXIBLE

Exploiting the benefits of global diversification, the fund aims to provide investors with an after-fee return of 5% per annum above the South African inflation rate.

FOR INVESTORS

- With a moderate risk profile
- Seeking long-term inflation-beating returns over periods exceeding five years
- Requiring a balanced exposure to South African and global investments.

### FOORD INTERNATIONAL (US$)

The fund aims to achieve meaningful inflation-beating US$ returns over rolling five-year periods from a conservatively managed portfolio of global investments reflecting Foord's prevailing best investment view.

FOR INVESTORS

- With a moderate risk profile
- Requiring diversification through investments not available in South Africa
- Seeking to hedge rand depreciation.

## REGULATION 28 FUNDS

### FOORD BALANCED

Managed to comply with the statutory investment limits set for retirement funds in South Africa, the fund aims to grow retirement savings by meaningful, inflation-beating returns over the long term.

FOR INVESTORS

- With a moderate risk profile
- Seeking long-term, inflation-beating returns over periods exceeding five years
- From an SA retirement fund investment product (Reg 28).

### FOORD CONSERVATIVE

Managed to comply with the statutory investment limits set for retirement funds in South Africa, the fund aims to provide conservative, medium-term investors with inflation-beating returns over rolling three-year periods.

FOR INVESTORS

- With a conservative risk profile
- Close to or in retirement
- Seeking medium-term, inflation-beating returns over periods of three to five years
- From an SA retirement fund investment product (Reg 28).

## SPECIALIST EQUITY FUNDS

### FOORD EQUITY

The fund aims to outperform the FTSE/JSE Capped All Share Index over the long term, with lower risk of loss.

FOR INVESTORS

- With a higher risk profile
- Seeking long-term growth over periods exceeding five years
- From a portfolio of JSE-listed equity, commodity and property stocks
- And able to withstand investment volatility in the short to medium term.

### FOORD GLOBAL EQUITY (US$)

The fund aims to outperform the MSCI All Country World Net Total Return Index from an actively managed portfolio of global equities, without assuming greater risk.

FOR INVESTORS

- With a higher risk profile
- Requiring diversification through investments not available in South Africa
- Seeking to hedge rand depreciation
- And able to withstand investment volatility in the short to medium term.



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