overberg asset management

**LOCAL PERFORMANCE FACTSHEET**

## OAM Local Income Portfolio[1]

**ZAR Rand**

## JUNE 2016

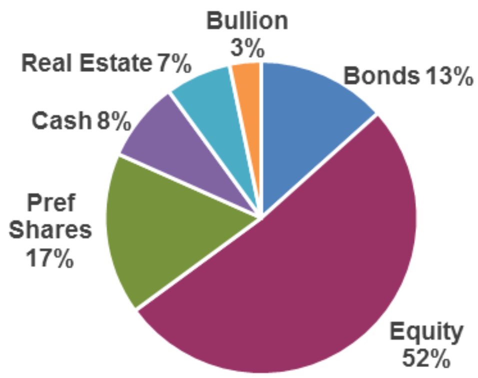
### Technical Details

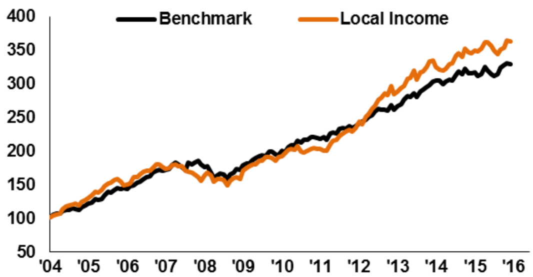
- **FSB** approved
- Base currency: **South African Rands**
- Minimum investment: **R750,000**
- Benchmark: **JSE AllShare (30%) and ALBI 1-3 yr Return Bond Index (70%)**
- Asset Allocation: **Flexible mix of equities, bonds and cash**

### Investment Objectives:

- conservative growth
- consistent annual returns
- low volatility

### ASSET ALLOCATION




(As calculated by Overberg 01 Jul 2016)

1) Individual portfolio representing Local Income investment style

| | Income % | Benchmark % |
|---|---|---|
| **Annualised Total Return** | 11.36 | 10.45 |
| **2004 (July – December)** | 18.33 | 14.20 |
| **2005** | 25.71 | 23.16 |
| **2006** | 14.50 | 21.94 |
| **2007** | 4.40 | 12.27 |
| **2008** | -10.60 | -9.99 |
| **2009** | 16.80 | 18.00 |
| **2010** | 11.73 | 11.90 |
| **2011** | 4.79 | 4.78 |
| **2012** | 22.86 | 14.38 |
| **2013** | 19.66 | 10.43 |
| **2014** | 3.67 | 6.98 |
| **2015** | 7.64 | 3.09 |
| **2016 YTD** | 2.04 | 4.58 |

*Since March 2005: All performance figures include income and are net of fees and expenses

| **Growth 2016** | **Income %** | **Benchmark %** |
|---|---|---|
| **January** | -1.96 | -0.82 |
| **February** | -1.40 | 0.47 |
| **March** | 1.84 | 3.35 |
| **April** | 0.68 | 1.17 |
| **May** | 3.36 | 0.99 |
| **June** | -0.40 | -0.60 |
| **July** | | |
| **August** | | |
| **September** | | |
| **October** | | |
| **November** | | |
| **December** | | |

| | % |
|---|---|
| **Annualised Income Yield** | 5.06 |

**Introduction**

Overberg Asset Management specialises in the management of individual portfolios, tailored to the investment objectives of each client. As an independent company, Overberg can set objective standards in its selection of investments. Privately managed portfolios provide clients with the optimal investment solution. Lower cost structures, greater manoeuvrability and meaningful exposure to smaller companies or tomorrow's "blue chips", all help to generate superior investment returns. Moreover, privately managed portfolios can be tailored specifically to individual requirements. At the cutting edge of investing, Overberg has a proven track record in global and domestic South African markets. Your portfolio will be in the safe custody of Nedbank Private Wealth, Investec Securities or Standard Equities.

**Quarterly Commentary 30 June 2016**

Following the extreme volatility in financial markets at the start of the year equities displayed greater stability in the second quarter (Q2), although positive returns were scarce. The rand benefitted from decisions by the three major credit rating agencies to leave SA's sovereign investment grade credit rating intact. The global search for yield prompted by a scaling back in the Federal Reserve's (Fed) interest rate hiking cycle also benefitted the rand. Meanwhile the shock Brexit vote has led to an increased likelihood of further monetary easing by the world's major central banks accentuating the search for yield and foreign capital inflows into the rand and other emerging market currencies. After giving up some if its Q1 gains during April and May the rand appreciated in June by 7.1% against the trade-weighted basket of currencies.

Commodity prices continued their modest upswing, helped by a weaker dollar and stabilisation in China's economy, propelling the Resources 10 index to a Q2 gain of +5.9% and +19.3% year-to-date (YTD). By contrast the Financial 15 index lost -7.3% in Q2 and -3.4% YTD, while the Industrial 25 index returned +0.2% and -1.1% over the respective periods. Overall, the All Share lost -0.6% over the quarter trimming its gains since the start of the year to +3.0%. Bonds performed better than equities. The global yield compression pushed the benchmark R186 government yield to its lowest levels since "Nenegate" last December comfortably below the key 9% level at 8.6%. The All Bond index (1- 3 year) increased from 385.78 to 397.46 returning +3.0% over the quarter and 6.0% since the start of the year. The dollar gold price performed well in response to negative interest rates in the Eurozone and Japan and the likelihood of increased global monetary easing. The dollar gold price increased from $1231 to $1348 in Q2, rising +9.5% over the quarter and +27.2% since the start of the year.

The latest set of GDP figures paints a somber picture of the local economy. GDP contracted in Q1 by -1.2% quarter-on-quarter annualised far worse than the -0.1% consensus forecast and down from 0.4% and 0.3% in Q4 and Q3 2015. Mining production fell by a substantial -15.5% and agricultural production by -6.5%. However, excluding these two sectors GDP would have increased 0.4% in Q1. The manufacturing sector grew 0.6% an improvement on Q4's -2.5% contraction. On the expenditure side, gross domestic expenditure shrank in Q1 by -0.7% compared with growth of 1.4% in Q4. Household consumption expenditure, for a long time the driving force behind economic growth, declined -1.3% in Q1 after growing 2.1% and 2.4% in Q4 and Q3 last year. Household finances deteriorated under the strain of mounting job losses, rising inflation and higher debt service costs. Growth in real personal disposable income slowed to only 0.3% in Q1 from an already modest 1.8% in Q4 last year. The escalation in political turmoil and social discontent since December last year probably added to consumer uncertainty. Total fixed capital formation fell by -6% in Q1 as both government and the private sector sharply reduced capital spending, by -11.9% and -6.8% respectively. The Reserve Bank indicated a widespread reluctance to expand capacity within the private sector.

GDP should recover in Q2 led by a stabilization in mining and agricultural output. The safety related stoppages which beset the mining industry in Q1 have not carried over into Q2, while receding drought conditions should lead to a gradual normalization in agricultural output. Manufacturing output should also maintain its recent positive momentum in line with the recent upturn in manufacturing purchasing managers' indices. However, growth in retail sales lost further momentum in April and the slump in new vehicle sales continued unabated in

June. The Bureau of Economic Research (BER) quarterly business confidence index fell from 36 in the first quarter (Q1) to 32 in Q2, its lowest level since 2009. Among the different sectors surveyed retailers led the decline falling from 44 to 26 its lowest since 2001. According to the BER report: “Not even during the global financial crisis-related downturn of 2008 and 2009 have retailers been this downbeat.” While consumption expenditure by general government may be propped up by election-related spending in Q3, overall growth will probably be contained given the need to reduce the budget deficit and to stabilise government’s debt burden.

The current account deficit widened to 5% of GDP in Q1 from 4.6% in Q4 last year. This was mainly due to a larger deficit on the services account, which outweighed the benefit of a narrower trade deficit. The services deficit increased to 4.1% of GDP from 3.6% in Q4, caused mainly by higher net dividend payments. The trade deficit should narrow further during 2016 from a combination of low international oil prices, weaker household spending and shrinking fixed investment. Export volumes and prices are forecast to improve but this will depend on a recovery in commodity prices and local producers’ ability to capitalise on the competitive boost provided by a weaker rand. This may prove difficult given softer global demand and the risk of output disruptions posed by infrastructure bottlenecks and labour relation tensions. The current account deficit is expected to narrow marginally from 4.3% in 2015 to around 3.5-4.0% in 2016.

Consumer price inflation (CPI) once again surprised on the downside in May, easing to 6.1%, down from 6.2% in April and 6.3% in March. Price increases moderated across a broad range of products and services while food prices encouragingly rose by a smaller-than-expected 0.2% over the month. Core inflation held steady at 5.5%. At its policy meeting in May the SA Reserve Bank (SARB) kept the repo rate unchanged at 7.0% citing better than expected inflation data. The SARB projected CPI would return to its 3-6% target range by Q3 2017 sooner than its earlier forecast of Q4. The forward rate agreement market has flattened in recent weeks following the strengthening in the rand and the outlook for more accommodative monetary policy from the world’s major central banks. Market expectations are now pricing in a 50% probability of a 25 basis point repo rate hike in November indicating no interest rate change in either July or September.

In Q1 the rand felt the effects of increased risk aversion among global investors towards emerging markets generally, and commodity-based economies particularly. However, more recently, a resumption of the global search for yield has resulted in significantly higher portfolio capital inflows into emerging markets and into South Africa specifically. The rand recovered strongly in June following key decisions by rating agencies S&P Global Ratings and Fitch to leave the country’s sovereign risk ratings unchanged, the neutral outcome of the Fed’s policy meeting, and indications of further monetary easing by the world’s major central banks post the Brexit vote.

However, we remain vigilant towards the rand’s direction despite the near-term improvement in sentiment. While a downgrade to sub-investment grade has been avoided over the near-term, the threat has not disappeared. S&P has kept SA on “negative watch” for a potential downgrade at the next bi-annual review in December. The broader macro-fundamental prospects remain negative characterized by persistent structural imbalances, and continued policy and political uncertainty. Moreover, foreign capital inflows are notoriously volatile vulnerable to the unpredictable mood of central bank policy and changing investor sentiment.

The Treasury announced that it would decide by year-end on how best to proceed with the restructuring of its portfolio of state-owned enterprises (SOEs) suggesting that some SOEs could either be merged, sold or closed-down. The Treasury’s announcement regarding SOEs is encouraging and deserves close attention for any sign of implementation. However, markets will likely remain wary until concrete plans are announced and there is a full buy-in from government.

While local equity markets have provided negligible returns over the past 12 months, valuations still remain stretched. The All Share index is trading on a price earnings (PE) multiple of around 22x. These are extreme valuations, well above the 14.8x historic average and the 12.8x emerging market average. However, there are segments of the market which offer considerable relative and absolute value. For instance, the JSE construction and building materials sector trades on a 7.9x PE multiple, around a third of the broader market's rating. The sector would be a clear beneficiary of any ramp up in infrastructure spending, which provides the easiest and most realistic means for SA to achieve a desperately needed inclusive economic recovery. The construction and building materials sector offers a typical "value" style investment opportunity. Although out of fashion with investors, the discounts to book value at which many shares in the sector trade, should provide significant downside protection in any equity sell-off. "Value" investing has consistently underperformed "growth" investing in recent years. However, the trend is gradually changing. As the broader market's valuations become increasingly excessive and out of synch with depressed economic fundamentals, the time for value investments to outperform is fast approaching.