overberg asset management

Local performance factsheet

OAM Local Real Return Portfolios
ZAR Rand

JUL 2014

Technical Details

- **FSB** approved
- Base currency: **South African Rands**
- Minimum investment: **R750 000**
- Benchmark: **Prime Interest Rate**
- Asset Allocation: **flexible mix of bonds, listed commercial properties, pref shares and ordinary shares.**

Investment Objectives:

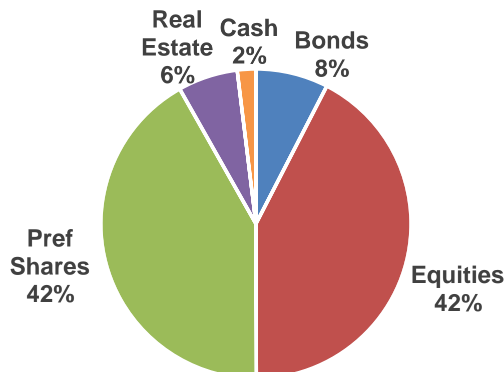
- conservative growth with income
- consistent annual real returns
- low volatility

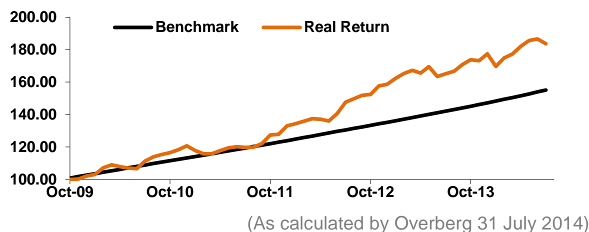
	Real Return %	Benchmark %
Annualised Total Return	13.65	9.68
2010	17.58	11.42
2011	10.14	9.38
2012	19.21	9.11
2013	11.86	8.84
2014 YTD	3.50	5.39

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

Growth 2014	Real Return %	Benchmark %
January	-4.35	0.75
February	3.10	0.75
March	1.37	0.75
April	2.71	0.75
May	1.93	0.75
June	0.54	0.75
July	-1.63	0.77
August		
September		
October		
November		
December		

	%
Annualised Income Yield	8.56





(As calculated by Overberg 31 July 2014)

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License No: 783. Company Registration No: 2001/019896/07.
Directors: Nick Downing, Brett Birkenstock, Gielie Fourie.

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 maneuverability 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.

Overberg's Real Return Portfolio is an enhanced alternative to either money market funds or bank deposits, offering the prospect of better after tax returns by generating a sizeable portion of income from dividends. Yield is increased by active management across SA government and parastatal bonds, pref shares and growth assets including listed commercial property and high yielding ordinary shares. Valuation volatility is kept at a minimal level with temporary valuation declines not expected to exceed 5% of the value of the portfolio at any point in time. This is achieved through disciplined asset allocation ranges, and diversification across asset classes and individual holdings. A small, actively managed exposure to growth assets will enhance after tax yields with a minimal increase in risk.

Quarterly Commentary 30 June 2014

It is incongruous that amid the worst strike in SA's history and a contraction in GDP in the 1st quarter (Q1) the JSE continued climbing to successive all-time record highs. The All Share index increased in Q2 by 6.64% taking its returns for the year to date to 10.14%. The Industrial 25 index was the top performer over Q2 with a gain of 9.24% and year to date of 9.42%. The Financial 15 gained 7.19% over the quarter but remained the top performer for the year to date with 13.78%, while the Resources 10 gained respectively by 2.52% and 11.69%. The rand showed very little volatility closing unchanged on the quarter versus the dollar at R/$ 10.59 and for the year to date has only depreciated by -0.95%. The stable rand helped the bond market in spite of hawkish statements from the SA Reserve Bank with the All Bond Total Return index (1-3 year) gaining over the quarter and year to date by 1.78% and 2.51%. The dollar gold price continued its recovery of the past 6 months rising 1.55% over Q2 and 8.86% since the start of the year.

The economic outlook is in sharp contrast to the buoyant equity markets. As expected Standard & Poor's credit rating agency downgraded SA's foreign currency credit rating by one notch from BBB to BBB- citing concerns over the large and rising fiscal and current account deficits, weak economic growth, on-going labour unrest and declining labour productivity, and the potential volatility and cost of external financing. Fitch rating agency affirmed South Africa's foreign credit rating but lowered the country's outlook from stable to negative, citing weak economic growth and a failure to boost growth potential, as well as persistent current account and fiscal deficits.

Although SA's current account deficit unexpectedly narrowed from 5.1% of GDP in Q4 2013 to 4.5% in Q1 beating the 6.0% consensus forecast the improvement is attributed almost entirely to a big jump in inward income inflows stemming from dividends earned on foreign portfolios. Dividend inflows are volatile and may largely be reinvested overseas which would entail a reversal in Q2. The trade deficit meanwhile deteriorated from 1.3% of GDP in Q4 to 2.1% in Q1.

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The current account deficit is likely to worsen again as the year progresses to around 5.4% for 2014 as a whole.

Mine workers finally returned to work in the final week of June, but the impact of the 5-month long strike will be felt for some time to come. According to the Chamber of Mines the 3 major producers lost R24 billion in revenue, suppliers to the mines lost R10 billion in revenue and workers lost R10.9 billion in income. There is also the threat of protracted industrial action in other industries, with NUMSA declaring a strike from 1st July and the public sector 3-year wage agreement coming up for renewal in July.

SA's Quarterly Employment Statistics show total formal non-agricultural employment increased in Q1 by just 9,000 following an increase of 41,000 in Q4 2013. Community, social and personal services, mainly in the public sector, increased employment by 50,000. In contrast, the private sector shed 41,000 jobs: The construction and financial services sectors gained by 5,000 and 7,000 but the retail and wholesale trade, mining, and manufacturing sectors respectively shed 34,000, 13,000, and 3000 jobs. Although the retail and wholesale sector is explained by a reversal of short-term seasonal hiring over the festive season, the overall loss mirrors underlying weakness in economic growth momentum. Since the end of 2010, private sector employment has increased by only 59,000 while the public sector has increased by 197,000. Moreover, the rate of increase in public sector employment is unlikely to be sustained given the government's strained finances and pressure to meet deficit targets.

Credit demand was little changed in May, with private sector credit extension growing by 8.3% year-on-year, unchanged from April. Loans to companies showed reasonable 13.3% growth but the slowdown in loans to households intensified, with advances growing by only 4.3% the weakest since 2009, down from 4.6% in April and 5.5% at the end of last year. Demand for credit is forecast to remain subdued, with pressure on household disposable income, rising debt service costs, high existing debt burdens, tightening of lending standards and weak employment growth.

The Bureau of Economic Research (BER) Business Confidence Index remained unchanged in Q2 at just 41. This means 59% of the surveyed respondents indicated that business conditions are unsatisfactory. The manufacturing confidence index fell sharply from 41 in Q1 to 25 the lowest reading since Q4 2009, attributed to the knock-on effect from the platinum strike, concerns over electricity supply, and the threat of further strike action in the steel and textile sectors. Among the bright spots, confidence in the retail sector recovered from 39 to 49, and in the motor vehicle sector from 27 to 39, together helping to stabilize the headline reading.

SA's GDP contracted in Q1 by -0.6% quarter-on-quarter annualised far worse than the -0.2% consensus forecast. The contraction, the 1st since the 2008/09 global financial crisis, is attributed to the platinum strike and electricity shortages which culminated in load shedding on 6th March. Outside of the affected mining and manufacturing sectors the rest of the economy only expanded at a modest pace of 1.8%. There is a risk that SA GDP could contract further in Q2 with 2 straight quarters of contraction meeting the technical definition of a recession: It will take time for the platinum mines to resume full operation. Meanwhile the manufacturing purchasing managers' index fell sharply from an average 50.6 in Q1 to 47.4 in April below the key 50 level which signals contraction. Furthermore electricity shortages are likely to accentuate during the colder winter months. In the nearer term wage discussions have already deadlocked into strike action in the engineering sector. The GDP outlook for SA has deteriorated sharply with growth of just 1.4% expected for 2014.

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Despite weak economic growth the upward trend in inflation continued in May, with headline consumer inflation rising from 6.1% to 6.6%, well above the SA Reserve Bank's (SARB) 3-6% target range. However, much of the rise was due to higher food prices. Encouragingly, core inflation, which excludes volatile food, petrol and energy costs was steady at 5.5% after rising to this level in March. Inflation is still expected to hit 6.8% by year-end, before dipping below 6% in the 2nd half of 2015. The biggest upside risk to inflation remains a vulnerable rand and rising global oil prices. Food prices are likely to moderate further amid record crop yields in SA and benign global food prices. However, the rand remains vulnerable to changes in global investor sentiment given the country's twin deficits and uncertain policy outlook.

As expected the SA Reserve Bank (SARB) left its benchmark repo interest rate unchanged at 5.5% citing slow global and local economic growth. The SARB's Monetary Policy Committee (MPC) faces a policy dilemma of containing mounting inflationary pressures without hurting an already weak economy. Within this weak environment, the Reserve Bank has maintained a hawkish tone, warning that "we are in a rising interest rate cycle, and interest rates will have to be normalized in due course." However, Deputy Governor Daniel Mminele has stressed that "the current rate cycle need not match the speed and magnitude of earlier cycles." A hiking cycle in modest increments seems the most likely scenario with one or two 25 basis point hikes taking place late in Q3 or Q4. However, if the rand holds at current levels or improves, the chances of further hikes this year diminish. The dampened growth outlook has eased the market's expectations of rate hikes. In January the Forward Rate Agreement market was pricing in close to 3 hikes of 50 basis points each before year-end. The market is now pricing in just under 1 rate hike of 50 basis points.

To the relief of financial markets the national election was conducted without serious incident. Yet the policy and economic outlook remains uncertain and the combination of slowing growth and rising interest rates is not appealing for either equity or bond markets. Furthermore equity value is becoming increasingly difficult to find with the All Share index trading on an estimated 18.7 forward price-to-earnings multiple, well over the 14 long-term average. As a result of the difficult macro-economic environment and high valuations we have steadily made the portfolios more defensive over the past quarter and envisage continuing the process over the 2nd half of the year. This will entail a move from equities into more defensive asset classes including preference shares and listed commercial property, and an emphasis on reducing exposure to small-cap stocks which tend to underperform in a weak market.

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