FOREWORD

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DID YOU KNOW?

QUANTITATIVE TIGHTENING

Quantitative tightening (QT) monetary policy is the reverse of quantitative easing (QE). Through QE, central banks create money to buy financial assets, principally bonds, to suppress interest rates in the economy. QE is a stimulatory process that injects significant amounts of liquidity into financial markets.

Under QT, central banks allow the accumulated bond holdings to slowly mature and may even sell bonds into the market. It is a contractionary monetary policy aimed at the slow withdrawal of liquidity from the financial system. The objective is to reduce massively swollen central bank balance sheets and allow suppressed interest rates to find their normal levels.

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THE YEAR IN REVIEW

What a difference a year can make. After a blistering 2017 when JSE and global equities surged over 20% and most asset classes delivered double digit returns, 2018 stood in stark contrast. MICHAEL TOWNSHEND looks back at the year that was.

In 2018, equity bourses varied from -4.5% in US dollars for the bellwether US markets to -14.2% for emerging markets. Commodity indices were lower and even global bonds showed negative returns.

The FTSE/JSE All Share Index fell 8.5% (-21.3% in US dollars) with several blue-chip stalwarts suffering heavy losses as the market de-rated companies that have exploited cheap leverage to make acquisitions. Nine ALSI 40 shares declined by more than 30% (of which six fell more than 40%). SA listed property stocks plunged 25.3%. In SA, only cash and the SA All Bond Index (+7.7%) produced real returns.

The global economy continued to deliver above trend growth as US corporate earnings were boosted by Trump's early tax cuts. The US Federal Reserve reacted to persistent economic growth by raising interest rates in four quarter-point increments but tellingly reduced its outlook for the number of hikes anticipated in 2019. Developed market bond yields continued to rise, with the US 10-year yield surpassing 3.0% intra-year before softening on safe-haven buying late in the year.

Major market inflection points are often associated with elevated volatility and increasing concentration of returns in a few counters. This was reflected on the JSE with the FTSE/JSE All Share Index fluctuating more than 5% twelve times during the year while US market returns were initially concentrated in the giant US tech stocks.

The world's central banks have signalled the end of the decade-long quantitative support by withdrawing liquidity from markets. Combined with rising interest rates and waning confidence as global trade tensions rose, support for ongoing market gains has steadily eroded. The remaining bulwark for the post global financial crisis bull market is earnings. But analysts' projections for growth have been tempered as the one-off boost of Trump's tax cuts works its way through the system and the economic outlook is increasingly murky.

South Africans welcomed with relief a new political order as President Ramaphosa moved to reverse some of the more insidious decisions made in the final stages of the Zuma era. Despite this positive political catalyst, the country slipped into two quarters of negative GDP growth. Business confidence languished amid political uncertainty while consumer spending was constrained by rising taxes, fuel prices and administered costs.

The rand weakened 13.5% against the US dollar on emerging market contagion risk following Turkish and Argentinian disruptions. Trade war escalation further exposed the vulnerability of small, open, twin-deficit economies to exogenous shocks. Severely stretched public finances limit the SA government's ability to meaningfully stimulate growth, making anaemic private sector fixed investment crucial for growth.

Given the outlook, Foord's multi-asset class portfolios reflected a more cautious approach, with equity exposure having been reduced early in favour of high-yielding, near-dated SA government bonds. Bonds were one of the few asset classes to deliver positive returns and they continue to offer an attractive real yield.

While many of the non-resource rand hedges underperformed, this foreign earnings stream should provide protection in a volatile currency environment. Caution remains the watchword, but the portfolio managers are vigilant for quality opportunities that will sustain long-term performance when the bears retreat.

THE BEARS ARE AT THE DOOR

(AND WHY WE SHOULD EMBRACE BEAR MARKETS)

PAUL CLUER Managing Director

One of the longest global bull markets in living memory wound down in 2018. PAUL CLUER takes a closer look at bear markets and what they mean for long-term investors.

Bear markets are periods of depressed or falling security prices. They are characterised by lower global liquidity, rising inflation, rising interest rates, negative earnings news and negative sentiment. They are often cyclical but are typically shorter than bull markets. Bear markets are also characterised by investor and media boredom. There is a lack of major news flow and there is little market excitement and no frenzy.

That markets fall or correct when interest rates normalise upwards should be no surprise. This is because interest rates are associated with the market's cap rate — lower interest rates mean the present value of future earnings is higher and vice versa with higher interest rates. Interest rates have been rising in the US for two years now and the US Federal Reserve's planned trajectory has spooked investors accustomed to artificially low rates for the past decade.

Equity market investors are naturally elated at rising share prices. We all feel wealthier — at least on paper. As fund managers, we understand that prices fluctuate far more widely than values. Rather than despairing over falling prices, we see long-term buying opportunities.

In our experience, it is particularly advantageous to identify a bear market early in its cycle. This allows for timely defensive positioning, as restructuring portfolios during a bear market can become impossible. This is because stock broking activity reduces substantially given the lack of greed and trading volumes. As a result, investors cannot buy or sell stocks in significant volumes and liquidity is only exhibited in the top 20 or 30 shares.

Foord's portfolios have been cautiously positioned for at least two years. We are often criticised for being early but long experience has shown that it's better to be early than late when the bears are at the door. It is therefore often better to sit on one's hands once a bear market hits, having already prepared portfolios.

Despite gloomy sentiment, bear markets are good for long-term investors because they provide opportunities to buy shares in good companies at great prices and often in large volumes. This is because markets are less efficient during bear phases as many market participants are selling for reasons unrelated to valuation, for example to reduce gearing or to raise liquidity. Buyers of shares can therefore pick up bargains provided they have enough cash or liquid investments like bonds which are typically resilient in bear markets.

Not all shares go down during bear markets. There are many more examples of shares going up in a bear market than shares falling in a bull market, where all shares tend to rise. This is because earnings become premium during bear markets, with investors willing to pay up for better earnings quality, more earnings certainty and real earnings growth. Nevertheless, the lack of significant market liquidity in a bear market can mean that quoted prices may still be too high since sellers could never dispose of major volumes at ruling prices.

Defensive positioning in advance of a bear market and limiting losses to 'less than market' declines are only half of the equation. More important is for the portfolio's securities to participate in market rallies after the bear phase ends. It is paramount that investors own companies that will not just survive, but will grow their earnings at above average rates when the global economy accelerates.

Investors should be able to cope with depressed earnings for a year or 18 months if faster earnings growth lies on the horizon. The most significant investment gains are achieved in the early stages of an ensuing bull market when long-term bargains are on the table. Investors must be invested when the turning point comes.

We often remind investors that all bear markets end. Sometimes this is difficult to envisage in the turmoil of market corrections. This bear market, too, will end — but not just yet. Normally, bear markets peter out when the interest rate cycle peaks, confidence returns and more money is available for the market. But we've yet to see the full effects of an unprecedentedly large quantitative tightening (see *Did You Know?*) cycle.

Financial markets lead the real economy by many months and so the end of the equity bear market will precede an improvement in the real economy's fundamentals. But investors shouldn't underestimate the power of sentiment, which can be most negative towards the end of the cycle.

It is during these final stages of a bear market that the best bargain purchases can be made and there could be some great investment opportunities to be taken in 2019, particularly if prices continue to trend lower. Now is the time for investors to demonstrate patience to allow their fund managers to find the investment winners in the next bull market.

"Despite gloomy sentiment, bear markets are good for long-term investors because they provide opportunities to buy shares in good companies at great prices and often in large volumes."

FULCRUM FEES – HOW THEY WORK

DIANE BEHR Operations Director

How much does a unit trust investment cost? Understanding the fee structure is an important consideration for any investment. DIANE BEHR takes a closer look at Foord's fulcrum fees.

Regulation strictly controls VAT-inclusive expenses, called *permissible deductions*, charged against unit trust portfolios. These are limited to the service charge, audit fees, brokerage costs and bank and settlement charges. The lion's share of these costs is the manager's service charge, which compensates the unit trust manager for the costs of scheme administration, including fees paid to the investment manager.

The Total Expense Ratio (TER) is a measure of each portfolio's total expenses over the past three years, expressed as an annualised average of the fund's market value. It includes all permissible deductions of the fund and underlying funds. It is a useful guide to historic costs but should be considered relative to performance if the fund charges performance fees.

Most Foord funds charge service fees based on the funds' performance relative to the benchmark return. The fees are typically structured as fulcrum fees, with fee rates increasing with outperformance and decreasing with underperformance around the at-benchmark (the fulcrum) fee rate. In our view, fulcrum fees align investor and manager objectives by rewarding the manager for good performance and penalising it for poor performance.

> "Most Foord funds charge service fees based on the fund's performance relative to the benchmark return."

The service fee is deducted from the unit trust price each day. The charge is calculated by applying the daily fee rate to the market value of the fund. For performance classes, the daily fee rate varies based on relative performance over a specified period. Foord's fulcrum fees calculate relative performance over rolling one-year periods for retail fund classes.

Performance fee rates are not capped because outperformance is never earned smoothly. And because fees reduce the fund's return, the base fee and all performance fees must effectively be recouped before another performance fee can be charged in the rolling one-year period. The minimum service charge in most Foord retail fund classes is 0.5% plus VAT per year.

As an example, and ignoring VAT, assume a Foord fund with an at-benchmark fee of 1% per annum achieves a one-year net-of-fee return of 10% when the benchmark return was 8%. The resulting outperformance is 2%. If the performance fee sharing rate is 10%, the performance adjustment is +0.2%. The service charge rate would be 1% plus the 0.2% performance adjustment, bringing the total to 1.2%. This result is divided by 365 to convert it to a daily rate, which is applied to the market value of the fund.

Similarly, if the fund's return was 10% and the benchmark return was 3% higher, the fund would have suffered underperformance of 3%. The performance fee adjustment would then be -0.3%, reducing the 1% at-benchmark fee to 0.7%.

In addition to Foord's service charge, fees may accrue in the Foord global funds which are underlying holdings in some Foord funds.

Please refer to the monthly fact sheets for details of all applicable fee rates.

FOORD IN BRIEF

TAX FREE ACCOUNTS

Investors who have not yet availed themselves of any tax free investment (TFI) products have until the end of the tax year to utilise this year's annual allowance of R33,000 per taxpayer across all TFI accounts. Foord offers tax free accounts in the Foord Balanced Fund, Foord Equity Fund and Foord Flexible Fund of Funds. Transfers into and out of TFIs are now permitted.

EXCHANGE CONTROL ALLOWANCES

Foord's global funds can be accessed by South African investors utilising their annual exchange control allowances. Every South African can spend up to R1 million per calendar year buying foreign exchange (the "single discretionary allowance"). This is a no-questions-asked facility that may be used for any legal purpose abroad, including investment. Investors should inquire about the process to transfer monies abroad from their bank, acting as an Authorised Dealer in foreign exchange.

In addition, every South African in good tax standing and over the age of 18 can apply to transfer up to R10 million per calendar year pursuant to a SARS Tax Compliance Status foreign investment allowance application. This is an online application process available from the Tax Status section of the SARS eFiling portal. The process involves the provision of a personal balance sheet and documents supporting the proof of monies and source of funds for the intended transfer abroad.

MARKETS IN A NUTSHELL

WORLD

EQUITIES

World equity markets sold off sharply — slowing Chinese growth, continued US-China trade conflict and tighter liquidity spurred investors out of risk assets

BONDS

US 10-year bond yields fell rapidly as investors fled to safe-haven assets resulting in the flattest US yield curve since 2007 — signalling market nervousness that the US economic expansion is ending

CURRENCIES

The US dollar gained against the euro and pound but was weaker against the yen — investors view the relative isolation of the Japanese economy as a refuge during bouts of market volatility

ECONOMY

Notwithstanding continued US economic strength, data indicating slowing ex-US growth unnerved markets — the economic expansion cycle is now decidedly late stage

MONETARY AND FISCAL POLICY

The US Federal Reserve raised its benchmark rate for the fourth time in 2018 and continued its balance sheet normalisation — the ECB is starting its own quantitative easing withdrawal programme

SOUTH AFRICA

EQUITIES

The JSE declined despite rand weakness buoying global companies listed on the bourse — several big non-resource rand-hedge stocks suffered steep sell-offs while SA Inc. companies were mostly lower

BONDS

SA government bond yields fell on safe-haven buying — the SA All Bond Index outperformed cash as the only asset classes to achieve a positive quarterly return

CURRENCIES

The rand weakened as investors sought refuge in traditional safe-haven currencies — open, twin-deficit economies remain vulnerable to quantitative tightening

ECONOMY

The economy exited the technical recession, but growth remains challenging — as demonstrated by Mboweni's sobering inaugural Medium-term Budget Policy Statement and Eskom load-shedding

MONETARY AND FISCAL POLICY

SARB raised interest rates in December despite the sharply higher fuel price and pressured consumer — but the Monetary Policy Committee was evenly divided, indicating moderating hawkishness

COMMODITIES

Precious metals gold and silver rose sharply as investors sought safe-haven stores of value — but oil fell heavily on surging US production and unexpectedly high post-sanctions Iranian production despite December's OPEC-agreed production cuts

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.

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

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