FOREWORD

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DID YOU KNOW? FEDERAL FUNDS RATE

The US Federal Reserve (the Fed) describes the federal funds rate as the rate at which depository institutions (the most creditworthy commercial and savings banks, savings and loan associations and credit unions) lend reserve balances to other depository institutions overnight.

The Fed uses open market operations — the purchase and sale of securities in the open market — to maintain the level of the fed funds rate within its target range, which is set by members of the Federal Open Market Committee. The fed funds rate was maintained at an effective 0% from December 2008 to December 2015, but has reached a high of nearly 20% in the inflationary 1980s.

The rate acts as a benchmark rate for the cost of credit and guides borrowing costs for everyone in the US, affecting monetary and financial conditions across the US and global economies.

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THE YEAR AHEAD

In November 2015, MIKE SOEKOE took the podium at Foord's investor functions to discuss the market volatility experienced in 2015 and Foord's outlook for investment markets in 2016. Below is an overview of his presentation.

It is well known that Foord adopts both a "top-down" and "bottom-up" approach to investment. The investment team first looks at the global economy in order to determine which sectors, currencies and asset classes are most likely to yield superior returns over the medium to long term (the top-down element). Next, the team examines the micro investment opportunities – those individual securities of shares, bonds and property stocks, in what weights, that will comprise the ideal portfolio (the bottom-up element).

> FOORD'S PREFERRED ASSET CLASS TO ACHIEVE INFLATION-BEATING RETURNS IN THE MEDIUM TERM REMAINS EQUITIES, MOST NOTABLY FOREIGN EQUITIES.

From a macro, top-down perspective, the global economy should continue its gradual growth path, if somewhat unsteadily at times. In the US, much-improved employment numbers, nascent wage growth and the improving housing industry will drive global growth to approximately 3.0% for 2016. The European economy is expected to continue to gain traction, benefiting from the stronger US economy, weaker euro and the low oil price. In China, robust, but slowing, economic growth is adding to global volatility as that economy transitions from an infrastructure- to a service-driven economic model.

As a consequence of stable US economic growth and nearly-full employment, the US Federal Reserve as expected, finally began the process of increasing interest rates, called "normalisation." Normalisation communicates the Fed's confidence in the sustainability of US economic growth and is likely to result in US long-bond yields rising from current low levels.

In South Africa, the rand weakened against the key developed market currencies by between 17% and 25% in the past 12 months. South Africa's twin deficits, which reduce the credit quality of South African securities, have persisted for some time. However, in past years, foreign portfolio flows into the South African equity and bond markets tempered the impact of these deficits on the extent of rand depreciation.

As the US normalises interest rates, bonds and equities of all emerging economies, South Africa included, become less attractive (see *The Implications of Rising Interest Rates*). The absence or reversal of foreign portfolio inflows, coupled with continued high deficits, will leave the rand extremely vulnerable to further weakness unless South African bond yields also rise. We therefore hold a very cautious view on investing in bonds this early in a rising interest rate cycle. Cash will almost certainly deliver a negative return after inflation. Given the risks to appreciable real returns on cash and bonds, Foord's preferred asset class to achieve inflation-beating returns in the medium term remains equities, most notably foreign equities.

From a bottom-up perspective, Foord's prudential portfolios typically have a full permissible allocation to foreign assets, especially foreign equities (there is almost no exposure to foreign bonds and cash levels are relatively low). The unconstrained Foord Flexible Fund of Funds holds 70% in equities, most of which are domiciled abroad (at the time of writing the fund held 68% of its total investments abroad). All of the Foord portfolios are positioned to benefit from investment in good quality companies with strong balance sheets, good cash flows, proven management teams and solid dividend yields. Exposure to commodity companies remains limited.

LIVING ANNUITIES –
OPTIMAL INVESTING DURING YOUR RETIREMENT

Retirement fund products such as pension, provident and retirement annuity funds offer some tax advantages during the accumulation stage of the retirement funding process. As a result, they are often recommended by financial advisers and widely used by investors. PAUL CLUER examines the investment options available to investors in the accumulation and drawdown phases of retirement.

Investments made into retirement products during the accumulation phase of the retirement funding cycle must comply with the prudential limits set out in Regulation 28 of the Pension Funds Act. This regulation limits the fund's exposure to various asset classes, most notably to a maximum of 75% in equities and a maximum of 25% offshore. The Foord Balanced Fund is managed to comply with the limits set down in Regulation 28 and is an ideal savings product for use during the accumulation stage of retirement saving.

Investors can consider a number of alternatives on their retirement from a retirement fund. The Income Tax Act sets out rules regarding the maximum percentage permitted for lump sums on withdrawal or retirement and the taxation of those lump sums on withdrawal or transfer to another retirement product, which information is beyond the scope of this article. What is relevant for this commentary is that some post-retirement products will compel continued compliance with the requirements of Regulation 28, while other financial products escape the provisions of the Pension Funds Act and allow a wider investment mandate to be applied.

Lump sum transfers on retirement to another pension or provident fund (including preservation funds) or the purchase of an annuity from a retirement annuity fund require the underlying investment portfolio to be compliant with Regulation 28 at a member level.

For investors using unit trusts as the underlying building blocks for their investments, this generally results in an investment into one or more balanced funds (high, medium or low equity funds).

> AN UNCONSTRAINED GLOBAL ASSET ALLOCATION MANDATE IS ENTIRELY CAPABLE OF DELIVERING BETTER RETURNS WITH THE SAME OR LESS RISK THAN A REGULATION 28-COMPLIANT FUND.

An alternative, however, is the purchase a "living annuity" from an authorised financial services provider. The term derives from a definition contained in the Income Tax Act, which contains the words, "an annuity purchased from a person or provided by that fund." There are accordingly two kinds of living annuities: those offered by third party life insurers and those offered by the retirement fund in which the amounts were originally accumulated.

The latter funds are subject to the prudential investment limitations contained in Regulation 28. However, an annuitant who opts for a living annuity offered by a third party life insurer is not subject to the prudential limits. It follows that such an annuitant has the option of selecting a fund that does not necessarily comply with Regulation 28, but which offers a more optimal and unconstrained investment mandate which might more appropriately manage both risk and return.

Foord has long held the vindicated view that the limitations of Regulation 28 curtail the possible returns and that an unconstrained global asset allocation mandate is entirely capable of delivering better returns with the same or less risk than a Regulation 28-compliant fund. The very point of choosing an investment portfolio for the living annuity is to ensure that the returns are sufficient to permit a drawdown capable at least of keeping pace with inflation for the duration of the annuitant's retirement.

Foord's Regulation 28-compliant Foord Balanced Fund has earned a compound annual return of 14.9% over the last seven years. Over the same period, the unconstrained Foord Flexible Fund of Funds has returned 19.4% per annum. Both funds have comfortably exceeded their benchmarks and in both cases inflation has amounted to some 5.5% per annum.

It stands to reason that investors who find themselves having to make decisions regarding living annuities may wish to consider annuities provided by third party life insurers that permit them to select an unconstrained asset allocation fund such as the Foord Flexible Fund of Funds as the underlying investment. In this way, the stability and consistency of the income stream drawn down from the living annuity may be better assured.

WHY INVESTING DIRECTLY ABROAD MAKES SENSE

Foord's international feeder funds remain an accessible solution to investing abroad. However, investors should consider accessing Foord's international unit trust funds directly. WILMA MOSTERT explains the process.

Funds that feed directly into international unit trust funds do so within an exchange control framework that is implemented by government and supervised by the South African Reserve Bank. Investors should be aware that while they obtain offshore exposure in feeder funds, they can only invest and withdraw rands: access to the foreign currency assets purchased with the investment contributions is strictly prohibited. Furthermore, feeder funds generally attract an additional marginal cost that can be avoided by investing directly abroad.

Every South African resident 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 tax payer in good standing and over the age of 18 can apply to transfer up to R10 million per calendar year pursuant to a SARS Tax Clearance Application. This is a two-page application form that involves a visit to SARS. We are available to assist with information on how to proceed with such an application.

THE ROLE OF CASH
IN YOUR INVESTMENT PORTFOLIO

People often use the phrase "cash is king" in times of uncertainty when the best perceived strategy is to sit on your cash until uncertainty fades. DARYLL OWEN explains the pivotal role of cash in the management of an investment portfolio.

In investment parlance, cash broadly refers to money placed on short-term, variable rate deposit with reputable banks such that it is readily available for deployment. Because banks face their own liquidity risks and may ultimately fail, cash is a not a risk-free asset class. However, it can be considered to be low risk because it is free from most other investment risks.

At Foord, we define risk generally as the permanent loss of capital and we strive to grow investors' real wealth in the long term. A meaningful cash allocation can help with both of these goals at different times in the investment cycle, while providing utility in other areas as well.

We all experience the natural tendency to defer purchases (spending in general) and to hoard our cash when we are feeling nervous about the future. In much the same way, portfolio managers faced with increased risks or uncertainty are able to increase a portfolio's cash component to levels they feel appropriate in the prevailing circumstances.

The Nobel Prize-winning economist Harry Markowitz once called diversification the only "free lunch" available to investors. In other words, diversification can deliver benefits over time at no additional opportunity cost. Cash has proved to be the best diversifier of stock market risk relative to other defensive assets and this first benefit alone justifies its inclusion in the portfolio. We have said before that the more conviction you have, the less diversification you need. Accordingly, the cash weighting in the portfolio comes down to the portfolio manager's judgement.

Next, consider the role of cash in combating the effects of inflation. Inflation corrodes investor wealth over time and epitomises an ever-present and meaningful investment risk. The cash that is held in your portfolio earns interest at the prevailing rate and the yield that you earn will typically track upwards as interest rates rise in response to rising inflation. In the medium to long term, cash will never provide a meaningful inflation-beating return on its own but it should work to maintain the purchasing power of one's capital.

Studies show that investors often sell part or all of their investments after a strong market correction and are slow to reinvest after markets have bottomed. These early periods of market recoveries often deliver the best investment returns and missing out on these periods can impair long-term performance.

To participate in the upside of a market recovery, one needs additional cash. Excluding leverage, holding cash in your portfolio through the cycle will provide the liquidity needed to invest in growth assets at the bottom of the cycle, when the risks are lowest. The cash exposure would also moderate the volatility experienced by the investor by mitigating the extent of the market corrections on growth assets such as shares and listed property.

The disadvantage of cash is that it may curtail the portfolio's investment performance in the short term. When securities markets are advancing aggressively, cash will typically be the worst performing asset class over the measurement period. This underperformance is known in industry jargon as "cash drag."

Cash therefore provides stability and a solid foundation for an investment portfolio, diversification benefits relative to other asset classes, protection against potential rising inflation, portfolio liquidity and the ability to take advantage of increased volatility.

THE IMPLICATIONS OF RISING INTEREST RATES

In early December 2015, the US Federal Reserve (the Fed) increased interest rates for the first time in nearly a decade. The timing and magnitude of this interest rate hike were amongst the most speculated in recent history. WILLIAM FRASER looks at the importance and implications of the Fed's decision to raise interest rates.

As a result of December's decision, the target range of the fed funds rate (see *Did You Know?*) was increased by 0.25%, marginally above the near-zero rate that was effectively maintained since the height of the global financial crisis in December 2008. The long-awaited decision signals the advent of an interest rate normalisation process that is expected to continue at a slow pace as US economic growth gains traction.

In contrast, the South African Reserve Bank (SARB) was forced to increase SA interest rates by 0.25% twice last year despite deteriorating economic conditions. The increases were in response to inflation risk posed by the rand's depreciation against the currencies of SA's major trading partners. While acknowledging the risks to growth, SARB expects the higher short-term rates to stabilise the currency and mitigate the risk of imported inflation. In some ways, the impending US interest rate increases forced SARB's hand: The alternative of unchanged SA rates in a rising Fed interest rate cycle would have been detrimental to the value of the rand, inflation and wage growth.

Notwithstanding the small size of the US interest rate increase and expected shallow cycle, the incremental increase will have some consequence. Firstly, after many years of stagnant or falling incomes, holders of cash deposits will start to see incomes rise, albeit slowly. This is positive for certain sectors of the economy, notably debt-free pensioners with the bulk of their savings in interest bearing securities.

In contrast, heavily indebted individuals may struggle to repay interest or capital on loans, particularly in an economy like South Africa's where wage growth now lags. As a result of the expected rise in defaults, banks will tighten their lending standards and become more wary to whom they lend. This will generally be negative for economic growth.

Slower economic growth has implications for government and company revenues, which will come under pressure. The consequence is negative for their current and capital expenditure budgets, but also on their cost of borrowing, which will rise to compensate lenders for the increased risk of default.

The level of interest rates is important for asset prices because all investments compete with each other on yield comparisons. As interest rates rise, other investments such as shares, bonds or property become relatively less attractive, affecting the price that investors will pay for such investments. Moreover, as we have seen, corporate profit growth slows when interest rates rise. This compounds the relative attractiveness of shares as an asset class and impacts the price-earnings multiple of the share market.

These are just some of the consequences of rising interest rates. While they appear to be negative it's important to remember that abnormally-low global interest rates have for the past seven years not reflected the reality of the business cycle. This is especially true of an economy like that of the US. Higher short-term interest rates will remind investors that cycles do exist and will enable central banks to react with more accommodative policies by cutting interest rates when the cycle turns once more, as surely it will.

MARKETS IN A NUTSHELL

INTERNATIONAL

EQUITIES

Global bourses (+5.7% in USD) recovered from the previous quarter's sharp sell-off – the recovery was concentrated in the developed markets and China, with key emerging markets continuing to decline

BONDS

Developed market bond yields rose moderately – the US Federal Reserve having communicated confidence in the sustainability of US economic growth and expectations that inflation would gradually increase to its 2% target

CURRENCIES

The US dollar appreciated against the euro in anticipation of greater policy divergence between the US and Europe – this trend should persist with further increases in US rates and potential additional European quantitative easing

ECONOMY

Consumer spending and confidence levels are rising in developed markets on the back of job creation and wage growth – partially offset by weak manufacturing which has been severely impacted by the collapse of investment in the resources sector, especially oil

MONETARY AND FISCAL POLICY

The US Federal Reserve raised interest rates for the first time in nine years by a cautious 0.25% – stressing that the path of policy normalisation would be gradual and was likely to peak lower than has historically been the case

SOUTH AFRICA

EQUITIES

The FTSE/JSE All Share Index (+1.7%) rose marginally with resource shares (-19.2%) heavily underperforming – non-resource rand hedge shares outperformed, benefitting from the substantially weaker rand

BONDS

SA bond prices (-6.4%) fell sharply following the shock reshuffling of three finance ministers in one week – investors reacted to government's commitment to fiscal discipline and prospects of a debt downgrade to junk status

CURRENCIES

The rand (-10.8% vs the US dollar) depreciated precipitously after the finance minister fiasco – but was already beleaguered by negative emerging market sentiment and rising risks of recession in South Africa

COMMODITIES

Commodity prices again declined sharply, led by oil (-23.6%) and palladium (-15.8%) – the stronger dollar and ongoing concerns regarding the economic slowdown in China, coupled with robust supply, continue to weigh on the commodity basket

ECONOMY

Notwithstanding a moderate recovery in third quarter GDP growth, prospects for the SA economy have worsened – low commodity prices, rising interest rates and elevated policy uncertainty weigh on business and consumer confidence, increasing the possibility of recession in 2016

MONETARY AND FISCAL POLICY

SARB increased interest rates to 6.25% in December – in a pre-emptive move to combat rising inflation expectations following rapid currency depreciation and the sharp decline in fuel prices moving out the of the inflation base

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*	8.9	-	9.2	4.9
Benchmark	9.5	-	8.9	1.2

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*	16.6	13.6	9.1	5.4
Benchmark	14.1	12.5	8.0	4.7

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*	15.9	21.4	20.6	14.0
Benchmark	11.2	10.5	10.0	1.5

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*	19.4	14.0	1.4	0.5
Benchmark	16.6	12.3	5.1	1.7

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*	14.9	28.2	36.6	19.6
Benchmark	11.8	23.4	34.7	11.9

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*	22.5	-	31.7	25.3
Benchmark	26.2	-	31.8	18.3

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 | A MEMBER OF THE ASSOCIATION FOR SAVINGS & INVESTMENT SA

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