# FOREWORD

## DID YOU KNOW? UCITS

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The term UCITS is an acronym of "Undertakings for Collective Investment in Transferable Securities" and was coined in a 1985 European Union Directive that had the objective of creating a pan-European investment funds framework. The idea was that once registered in one country, a UCITS fund could be freely marketed across the European Union – thereby furthering the goal of financial services integration in the Eurozone.

The 1985 directive became known as UCITS I. The UCITS II project was abandoned and, in 2001, the UCITS III directive was issued which is still in force today. This directive was issued in two parts and regulates both management companies and investment funds. Investment funds are still created in many different legal formats throughout the EU but they may only apply for UCITS status if they meet the strict UCITS criteria.

The UCITS framework has become so successful that almost 70 countries around the world automatically allow UCITS funds to be marketed in their jurisdictions. In Europe, approximately 76% of the €6.8 trillion invested in investment funds are in UCITS compliant funds. The success of the UCITS framework is attributed to the high level of investor protection embodied in the law.

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# THE PROBLEM WITH RISK

**Foord has long held the view that volatility of returns is not a suitable measure of investment risk. Yet the investment fraternity seems preoccupied with this measure for determining whether or not an investment fits a particular risk profile. PAUL CLUER explains.**

In financial theory, volatility is a measure of the dispersion of returns. The wider the range of returns recorded, the greater the volatility. Take a look at two asset classes: equities (jargon for listed shares) and cash. At the one extreme, equities have reflected the widest range of returns historically, while cash has the lowest range. This makes complete sense because for many reasons the market struggles to put an accurate value on listed companies and changes its mind frequently over the short term, leading to volatility.

The "information ratio" tries to improve on pure volatility, which at its extreme would recommend that all investors seek the lowest volatility investment even though it yields the lowest long-term real returns. The information ratio is the return earned divided by the risk taken (measured by volatility) to get there. The higher the ratio, the more return you are getting per unit of volatility taken. However, the denominator of "risk-adjusted" measures remains the historic volatility of recorded returns.

Should any reliance be placed on volatility? An examination of monthly returns on the JSE from January 1926 to January 2013 (a period of 87 years) by Darron West of the University of Cape Town shows that there is no permanent relationship between volatility and return, volatility is not constant, and volatility in one period is almost useless in predicting volatility in a subsequent period. Furthermore (and fundamentally for the long-term investor), volatility is measured over a specific (often short) period, thereby imputing a short-term mindset to risk measurement for a long-term investment.

> "THE RISK OF BEING WRONG CANNOT BE CONTROLLED WITH REFERENCE TO VOLATILITY. IT CAN ONLY BE GUARDED AGAINST BY CAREFUL MANAGEMENT OF SCENARIO OUTCOMES AND APPLYING PROBABILITIES BASED ON JUDGEMENT."

To be fair, the investment industry has tried to make better sense of risk. Value investors prefer to refer to risk as "the risk of permanent loss of capital" – a forward-looking concept. Proxies for this might include "drawdown" (i.e. the worst return over a period) and the frequency of negative returns over various periods. Neither of these is dependent on volatility of returns for its measurement, but both metrics remain backward-looking.

The important prospective, immeasurable risk of being wrong cannot be controlled with reference to volatility. It can only be thwarted by careful management including a consideration of scenario outcomes and applying probabilities based on judgement. We use this concept widely at Foord when making investments for our clients.

So risk means different things to different people, but it most assuredly is not volatility. Yet the greater financial fraternity embraces the concept and new regulations are pending that will force all South African investment firms to give their unit trust funds a risk rating based on volatility (likely to be measured from week to week over a period of 60 months). We ask our clients to keep some perspective in evaluating these "risk" measures. In our view, those who have been fooled by theoreticians into believing that volatility equals risk have suffered the consequences of lower returns.

# FIT'S FUTURE – GUERNSEY MEETS LUXEMBOURG

**We have written before in this newsletter on the history and development of the Foord International Trust ("FIT"). In brief, the fund was launched as a Guernsey Class B collective investment scheme (unit trust) in March 1997. Over its 16-year history it has achieved an enviable track record and has grown to $1.7 billion in size. PRAKASH DESAI lays out Foord's plans for FIT's future.**

Guernsey has proved to be an excellent jurisdiction. It has a sizable and well-regulated financial services industry, skilled professionals and a legal system closely aligned to that of the UK. The Channel Islands of Guernsey and Jersey are British Crown dependencies. This means that they are not part of the United Kingdom but are possessions of British monarchy. As a result, unlike the UK, they are not member states of the European Union.

Their status as non-EU members has afforded the Channel Islands much freedom in setting flexible laws and regulations. However, the Channel Islands have been increasingly closed to the investment funds market because no Channel Island investment fund can attain UCITS accreditation (see *Did You Know?*). This means that Guernsey and Jersey unit trusts cannot be easily marketed in the Eurozone and many other jurisdictions such as Hong Kong, Singapore and Switzerland (Switzerland is also outside the EU and cannot approve UCITS funds but does endorse the framework and allow UCITS funds to be distributed in Switzerland).

Luxembourg is the leading European funds market with over 25% of Europe's investment funds by value. With over €2.3 trillion in funds under management, Luxembourg comprises almost 10% of the world's total funds market. As an EU member state, Luxembourg can accredit funds as UCITS compliant. Of all the EU member countries, Luxembourg has the most widely distributed UCITS within and outside of the Eurozone.

To take advantage of the UCITS framework and Luxembourg as a centre of excellence in the funds market, Foord has launched a UCITS compliant fund in Luxembourg, called Foord International Fund, a sub-fund of Foord Sicav. Unlike the UK-centric term "unit trust," most EU funds are open-ended investment companies with variable capital. In Luxembourg these are known as Sicavs and the Foord Sicav follows this format.

Through a process known generically as a "redomiciliation," we were able to transport the investment strategy and parameters of FIT to Luxembourg and thereby ensure that the new fund carried FIT's performance track record (for all intents and purposes it's as if this new fund has been going for 16 years). In this process, the assets of FIT were moved from Guernsey to Luxembourg.

As a result of this restructure, FIT has become a feeder fund feeding into the Luxembourg Sicav. The fee on FIT has reduced to zero while the Foord International Fund now carries the 1.35% fixed fee previously charged in FIT.

This master-feeder structure with the master fund domiciled in Luxembourg follows an accepted trend abroad. Many existing non-EU domiciled funds have converted to feeder funds with the master fund being located in an EU jurisdiction where it can gain the UCITS accreditation. Numerous Channel Islands funds now feed into UK-domiciled UCITS master funds while countries like Switzerland have funds that feed into Luxembourg UCITS portfolios.

For investors in the Foord International Trust, it is "business as usual" as they remain invested in, and transact with, the Guernsey-domiciled fund. There is no change in the investment strategy or management style and no change in the effective fee structure. The only change, however, is the appointment of Grace Ruddy as Securities Dealer in Foord's Guernsey office (see *New Faces at Foord*). Investors now have the additional peace of mind knowing their investment complies with the world's most widely accepted investment framework, the European Union's UCITS directive.

**"GUERNSEY HAS PROVED TO BE AN EXCELLENT JURISDICTION. IT HAS A SIZEABLE AND WELL-REGULATED FINANCIAL SERVICES INDUSTRY, SKILLED PROFESSIONALS AND A LEGAL SYSTEM CLOSELY ALIGNED TO THAT OF THE UK."**

# FOORD EQUITY FUND

## CONSISTENT RETURNS OR RANDOM OUTCOMES?

**Some financial market commentators suggest that active fund management offers nothing more than random outcomes and that a single active manager cannot deliver superior performance that persists over time. MIKE SOEKOE, with input from Darron West of the University of Cape Town, takes a closer look at the argument that a fund manager who outperforms the market in one period is likely to underperform subsequently, with specific focus on Foord's long-term investment track record.**

Many of the studies that examine the phenomenon of underperformance following outperformance use relative rankings of fund managers to draw their conclusions. However, this confounds the analysis as a fund manager who is capable of delivering consistent absolute outperformance might enjoy a high relative ranking in one period and a lower one the next, owing to nothing more than the vagaries of the market and the 'noise' of the returns of other managers. It has also been asserted that if performance persists at all, it is only for a short time. This too fails to give credence to the rare manager who can continually generate alpha (market jargon for outperformance).

It is important to differentiate between 'consistency' and 'persistence'. A consistent return is a quantum that tends to be steady or stable. A persistent return is one that endures over time. In the context of an excellent equity fund, one is seeking consistent alpha that persists.

Foord Asset Management makes no secret of its long-term perspective. It is also true that over the long term, equity is the asset class that has provided the highest returns. The long-term real (i.e. after adjusting for inflation) average annual return on South African equities over the past 29 years is 8%. By contrast, Foord Asset Management's long-term real average return from equity funds over the same period is almost

> "IN THE CONTEXT OF AN EXCELLENT EQUITY FUND, ONE IS SEEKING CONSISTENT ALPHA THAT PERSISTS."

double the market's at 15.6% (reflecting alpha of almost 8% per annum).

We should all be asking if this alpha has been consistently delivered. To answer this, the average alpha across all periods from 1 year to 20 years was examined and shown to have a very small range between 7.5% and 8.3% per annum. There can therefore be little dispute as to the *consistency* of the outperformance.

But is outperformance in one period followed by similar outperformance in subsequent periods (i.e. does performance persist)? If performance were not persistent (or merely random), one would expect a 50% chance of outperformance in the subsequent period to prevail throughout. The evidence shows that regardless of the initial holding period (whether as short as 1 year or as long as 10 years) and regardless of whether the onerous 8% p.a. alpha was achieved in that holding period, an investor has even odds of outperforming the market by 8% p.a. if he or she holds for another 4 years. The odds increase to 80% or more for subsequent holding periods greater than or equal to 8 years.

The analysis shows that active fund management can be beneficial to investors. It is possible to beat the market, even over the long term. The rewards of active equity fund management accrue over such longer investment periods, which is entirely consistent with the requisite mindset for equity investments.

# NEW FACES AT FOORD

We've welcomed a few new faces to the Foord team during the past quarter.

PRAKASH DESAI
CHIEF OPERATING OFFICER: FOORD INTERNATIONAL

Prakash joined Foord in November 2012, after retiring as a senior partner of Deloitte in Singapore. His role as COO of Foord's international operations will be to manage and oversee all non-investment activities of the global business. Prakash has been appointed to the boards of Foord (Guernsey), Foord (Singapore) and Foord Sicav, the newly formed investment company in Luxembourg (See *FIT's future – Guernsey meets Luxembourg*). Prakash holds a B. Comm (Accounting) from University of Durban Westville, B.Compt (Hons) degree from UNISA and is a registered chartered accountant (CA) in South Africa, ACA in Australia and CPA in Singapore.

Grace has been appointed in Foord's Guernsey office as a securities dealer for the Foord Sicav sub-funds, domiciled in Luxembourg (see *FIT's future – Guernsey meets Luxembourg*). She will also assist the international securities dealing efforts for the Foord Global Equity Fund, domiciled in Singapore, by covering the western markets while the Singapore-based team focuses on the Asian and Australasian share markets. Grace holds a BA (Hons) degree in Economics and Politics from the University of York and an M.Sc. in Economic Policy from the University of London and is a UK Chartered Accountant.

GRACE RUDDY
SECURITIES DEALER: FOORD INTERNATIONAL

HEATHER McCULLOCH
REGIONAL HEAD: RETAIL INVESTMENTS (WESTERN CAPE)

Heather joins Mike Soekoe's business development team as the regional head of retail business in the Western Cape. This team prioritises the financial advisor market by sharing and communicating the Foord investment philosophy, approach and excellent long-term track record. Heather has enjoyed a very successful career in retail investments, having worked for Allan Gray for almost a decade before joining the RE·CM team in 2009, where she made a big difference to the distribution efforts for their retail unit trust products over the last three years. We are very pleased to welcome her to Foord.

# MARKETS IN A NUTSHELL

## INTERNATIONAL | SOUTH AFRICA

### EQUITIES

**International:** Global stock markets were buoyant, led by the US (the Dow Jones closed at a record high on 5 March) and Japan – but emerging markets traded lower to significantly underperform the world majors

**South Africa:** The FTSE/JSE All Share Index rose by 2.5% – resources and consumer shares underperformed, while non-commodity rand hedges benefitted from the rand's significant depreciation

### BONDS

**International:** The US 10-year yield rose on improved investor risk appetite – but yields in the UK and main Eurozone economies fell marginally while yields on Japanese bonds fell heavily on continued stimulus measures

**South Africa:** Bond yields rose, as the deteriorating current account and budget deficits increase the risk of further sovereign rating downgrades – although foreign investors continued to support the market in Q1

### CURRENCIES

**International:** Sterling (UK ratings downgrade) and the yen (anticipated quantitative easing) were the worst performing developed market currencies – while the euro retraced earlier gains following inconclusive Italian election results and the €10 billion Cypriot bailout

**South Africa:** The rand weakened sharply as the current account deficit worsened and continued agricultural labour unrest negatively affected sentiment – with all the major ratings agencies maintaining their negative outlooks on the country and currency

### COMMODITIES

The gold price fell to a six-month low on gold's declining safe-haven appeal given stock market stability – industrial metals prices and oil also declined over the quarter

### ECONOMY

**International:** Growth in the US (the housing market recovery and employment creation offsetting public sector spending cuts) and China continues – but contractions in the Eurozone, UK and Japan are likely to be exacerbated by the Cypriot crisis

**South Africa:** GDP growth was a pedestrian 2.5% in 2012, weighed down by a weak mining sector – but the current account deficit soared to 6.3% of GDP as rising consumption and infrastructure related imports compounded anemic mining export volumes

### MONETARY AND FISCAL POLICY

**International:** Global "currency wars" intensified as the Bank of Japan doubled its inflation target to 2% – pledging to buy unlimited quantities of government debt to achieve its goal, thereby devaluing the yen and making Japanese exports more competitive

**South Africa:** Government and household consumption expenditure together with gross capital formation showed strong increases vs Q1 2012 – but slowing government spending and real disposable income growth for households are headwinds

## FOORD FLEXIBLE FUND OF FUNDS

### INVESTMENT RETURNS

| | Since Inception % | 3 Years % | 1 Year % | 3 Months % |
|---|---|---|---|---|
| Foord* | **14.1** | 21.3 | 29.0 | 10.2 |
| Benchmark | **11.6** | 10.4 | 10.8 | 2.1 |

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.
Inception date: 1 April 2008

### OBJECTIVE

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, but who do not require a high income yield.

## FOORD INTERNATIONAL FEEDER FUND

### INVESTMENT RETURNS

| | Since Inception % | 3 Years % | 1 Year % | 3 Months % |
|---|---|---|---|---|
| Foord* | **11.3** | 15.2 | 31.1 | 14.2 |
| Benchmark | **5.9** | 8.2 | 20.4 | 8.9 |

Benchmark: The ZAR equivalent of the MSCI World Equities Index (developed markets)
Inception date: 1 March 2006

### OBJECTIVE

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 Trust, 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.

## FOORD BALANCED FUND

### INVESTMENT RETURNS

| | Since Inception % | 3 Years % | 1 Year % | 3 Months % |
|---|---|---|---|---|
| Foord* | **17.6** | 15.7 | 21.5 | 5.8 |
| Benchmark | **14.9** | 12.3 | 17.2 | 6.5 |

Benchmark: The market value weighted average total return of the South African Multi Asset High Equity unit trust sector, excluding Foord Balanced Fund.
Inception date: 1 September 2002

### OBJECTIVE

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 (Regulation 28 to the Pension Funds Act). The fund is suitable for pension funds, pension fund members, holders of contractual savings products, medium- to long-term investors and those investors who require the asset allocation decision to be made for them, within prudential investment guidelines.

## FOORD EQUITY FUND

### INVESTMENT RETURNS

| | Since Inception % | 3 Years % | 1 Year % | 3 Months % |
|---|---|---|---|---|
| Foord* | **21.0** | 20.4 | 23.0 | 4.8 |
| Benchmark | **17.7** | 14.9 | 22.5 | 2.5 |

Benchmark: Total return of the FTSE/JSE All Share Index
Inception date: 1 September 2002

### OBJECTIVE

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.

**NOTE:** Investment returns for periods greater than one year are annualised  * Class R, Net of fees and expenses

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



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