FOREWORD

DID YOU KNOW? HYPERINFLATION

Hyperinflation describes excessive, accelerating and out-of-control price increases in an economy, at rates typically measuring more than 50% per month. Ballooning money supply coupled with demand-pull inflation (when demand for goods or services exceeds the supply) are the principal causes of hyperinflation.

At hyperinflation rates, everyday staples might cost one amount in the morning and another by the afternoon. As hyperinflation expectations become entrenched, consumers panic buy goods to avoid paying higher prices later. This activity fuels the hyperinflation, especially if stockpiling causes shortages.

Rapidly rising prices devalue an economy's currency versus hard currencies where prices are much more stable. Consumers respond by flogging the currency for stable currencies, exacerbating the depreciation. Monetary authorities often respond by printing more money to account for higher prices instead of drastically reducing the money supply. Eventually the currency becomes worthless.

Zimbabwe is a classic example, with hyperinflation reaching an estimated 79,600,000,000% per month in November 2008 (98% per day)*. Other examples of hyperinflation include the United States during the US Civil War, Germany after WWI and mostly recently Venezuela (ongoing).

* On the Measurement of Zimbabwe's Hyperinflation, Steve Hanke and Alex Kwok

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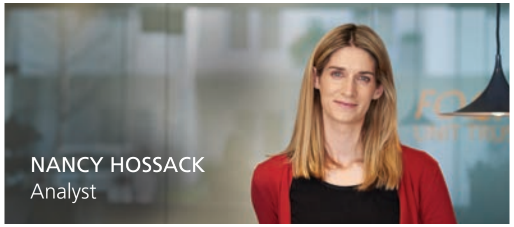
A RECIPE FOR DEALING WITH RAND STRESS


NANCY HOSSACK
Analyst

Of all the sources of financial stress, rand volatility is surely topmost for South African investors. As a nation, we obsess about the rand and its trajectory. Analyst NANCY HOSSACK describes a simple strategy for investors to manage currency stress.

Just north of South Africa's border is a clear example of what can happen to the savings of citizens when authorities grossly mismanage the economy. The Zimbabwean dollar was introduced in 1980 but became worthless and was abandoned in 2009 after economic mismanagement triggered sustained hyperinflation (see *Did You Know?*).

> "In five or ten years' time it won't matter much whether you traded one month or the next."

In developed economies, the actions of governments and central banks are inching closer to emulating the principles of Modern Monetary Theory (MMT). MMT proposes that authorities pay for goods and services by printing money instead of borrowing money. It suggests taming ensuing inflation by using higher taxes to reduce money supply. This seems to be a dangerous economic experiment to me even if executed perfectly.

You should therefore manage your currency risks no matter where you live. Managing investment risk is what we do at Foord. We can apply portfolio management principles to help investors manage their currency risks. I follow three simple rules that everyone should consider for their personal investments.

The first rule is to diversify. When it comes to currency, this means you should take money offshore. The South African Reserve Bank allows financial institutions to take up to 40% of retail investments abroad. We think this should be higher, so target 50% of your discretionary investments but have regard for your unique circumstances. Use your annual discretionary and investment allowances to buy dollars for this purpose—feeder funds give you offshore exposure but are not hard currency assets.

Secondly, apply rand cost averaging to mitigate the risk of extreme price points. With foreign exchange, this means taking money abroad regularly to achieve a blended exchange rate. South Africa has one of the world's most volatile currencies. We often see panic buying of dollars when the rand blows out, with investors getting the worst possible exchange rate.

Over time, the rand has depreciated by 4–7% per annum against the US dollar. There is nothing in South Africa's economic fundamentals that suggests this long-term trend should reverse. So, while you should avoid panic buying during currency blowouts, don't otherwise be too cute with the exchange rates you achieve. In five or ten years' time it won't matter much whether you traded one month or the next. The important point will be that you did.

Finally, the third rule is to follow the first and second rules and then to relax. Stop trying to micromanage your investments. The rand is volatile, which means you may sometimes see negative rand returns from your offshore investments. If you followed the second rule, you would have achieved a fair exchange rate on your foreign investments and bouts of rand strength should be impermanent.

INFLATION — THE BIGGEST DESTROYER OF CAPITAL

Inflation in the principal developed economies has been a subdued affair for the past quarter-century. But it hasn't always been so. WILLIAM FRASER discusses inflationary pressures in the world's developed economies.

Inflation in the US, Eurozone, UK and Japan has been anaemic, rising on average just 1.5% per annum since 1995. In the mid-1970s, however, inflation had averaged 10% per annum in the decade to 1982. The genesis of that inflation cycle was past central bank policies that caused excessive money supply growth.

After World War II, the US Congress mandated the US central bank to also promote full employment—in addition to stable prices and moderate long-term interest rates. But history later taught central bankers that permanently lower levels of unemployment came with much higher inflation.

By 1971, US money supply growth threatened a run on Fort Knox, which held only a third of the gold needed to cover US dollars held by foreigners. President Nixon then severed the link between gold and the dollar. The Bretton Woods system collapsed, birthing the paper money system.

Unshackled from gold, US money supply accelerated amid overly accommodative monetary policy (interest rates were too low) and major fiscal spending programmes. The US economy was already dealing with abnormal federal deficits from the Vietnam War. Two oil crises added to inflationary pressures through cost-push inflation.

US Federal Reserve chairman Paul Volcker finally tamed the US inflation cycle by curbing money supply growth and ultimately pushing US interest rates to historic highs of 20% in the early 1980s. This tipped the US economy into recession, but it later rebounded at structurally lower levels of inflation.

US inflation has rarely exceeded 3% in the last three decades. Some of this is due to productivity growth and the deflationary effects of globalisation—subdued developed world wages and cheap imports out of China.

Sustained increases in money supply above the growth of available goods and services have been the cornerstone of all inflationary cycles. In extreme circumstances, hyperinflation (see *Did You Know?*) leads to a complete collapse of purchasing power, rendering a currency worthless.

What are the lessons for policymakers today? Now, as in the 1970s, money supply is elevated. Central banks have pumped vast sums of money into keeping people employed and supporting the unemployed. Interest rates are at multi-generational lows. This started with 2008's Global Financial Crisis (GFC) and persisted through the Eurozone and Brexit crises. The monetary response to the COVID-19 crisis dwarfs all earlier central bank stimulus.

This massive, decade-long growth in money supply hasn't yet caused higher inflation. However, other inflationary forces are starting to build. Donald Trump began a de-globalisation trend and abandonment of free-trade arrangements. Shortages of key products during the COVID-19 lockdowns have compounded prevailing political pressure in the US and EU to onshore production of goods. Rising costs of production will almost certainly put upward pressure on wages.

We are therefore now seeing cost-push inflationary forces during a period of excess money supply growth. As we saw in the 1970s, this is not good news for inflation. Moreover, the US Fed recently changed its monetary policy framework to target average inflation: it now tolerates higher inflation if the average rate does not exceed 2%. In other words, lower levels of inflation in the past justify higher future inflation.

There are two important implications of this policy change. Firstly, the US Fed will allow US inflation to overshoot its long-term target. Thus, near-term inflation is likely to be higher than previously thought. Secondly, interest rates will stay lower for much longer.

> "The massive, decade-long growth in money supply hasn't yet caused higher inflation. However, other inflationary forces are starting to build."

Higher inflation with ultra-low interest rates is negative for savers in cash and bond instruments as the yield after inflation will be more negative. But it is positive for borrowers like governments—taxes will rise and the debt burden will deflate. It's no surprise that overindebted authorities are willing to tolerate more inflation.

Inflation is the biggest destroyer of capital in the long term. How can investors manage this risk in their investment portfolios? Holding gold (and, to a lesser extent, other commodities) has conventionally hedged inflation risks over time. Gold therefore has a place in portfolios.

Investors should undoubtedly avoid low-yield investments which perform worst during bouts of inflation. This includes negative-yielding bonds and credit instruments where the yield does not justify the risk of default. Inflation-linked bonds only offer some protection if real yields are positive. This is the case in South Africa, but not in the developed economies.

The best way to protect capital from inflation is to invest in capital assets that produce income that rises with inflation. Real estate has traditionally been resilient because rent reversions keep pace with rising inflation and rising commodity prices inflate the values of completed buildings—but the sector faces headwinds from online shopping and work-from-home trends, as well as high levels of indebtedness.

Share investments offer the best prospects during inflationary cycles. But not all companies offer inflation protection—some are price takers and face margin contraction with rising input costs. High dividend yield stocks—known as bond proxies—behave more like bonds and trade lower. Instead, investors should favour cash-generative companies with pricing power that can pass on higher costs to consumers.

Retail investors will need to be in funds that mitigate the risk of rising inflation while offering good geographic and asset class diversification. Unconstrained flexible funds are ideal, as are balanced funds for investors in retirement products. Conservative investors who are at or near retirement might consider medium equity funds as an alternative. Cash, income and bond funds cannot adequately deal with the risk of rising inflation and should be used at the margin only.

That said, inflationary shocks aggressively rising prices are a headwind to corporate investment and economic growth. Periods of abnormal inflation are negative for most asset prices. Hyperinflation in one or more economic blocs is a remote but growing risk. You don't want to be there if it happens.

FOORD EQUITY FUND — BENCHMARK AGNOSTIC

The Foord Equity Fund has a stellar track record but has lagged its index benchmark in the last five years. Lead portfolio manager NICK BALKIN revisits the fund's value proposition and prospects.

The Foord Equity Fund has an explicit index benchmark despite our investment philosophy being benchmark agnostic. That means that we don't choose our share investments based on the composition of the benchmark. Instead, we apply an absolute-return, risk cognisant mindset to share selection and portfolio positioning.

We build diversified portfolios concentrated on our best share ideas which we believe will deliver excellent risk-adjusted, long-term returns. If we get this right, the portfolio should outperform all indices constructed by arguably arbitrary rules over full market cycles.

The alignment of interests inherent in Foord's owner-managed team results in a natural buy-and-hold investment strategy that works to grow our investors' wealth in real terms over time. This allows the team to stay focused on the long-term fundamentals of the companies we buy.

Foord has guided investors for some years on our cautious positioning. The firm has avoided most companies with significant exposure to the beleaguered South African economy, preferring non-resource rand hedge companies with better earnings certainty. Examples are leading luxury goods company Richemont, tobacco and vaping giant British American Tobacco, and brewer Anheuser-Busch Inbev.

The fund's low weight to the mining sector has been a significant detractor of index-relative performance given the resource sector rally. This mirrors the fund's underperformance leading up to the 2008 global financial crisis, when resources outperformed materially.

Now, as then, there is a clamour from investors for resources stocks. But we are very worried about valuations, sustainability of resources prices, quality of earnings (miners are price takers) and the inherent risks of operating in unstable jurisdictions (it is easy to tax a mine that makes lots of money and can't move).

Investors also overlook the very real risk of overexposure to the Chinese economy inherent in most South African equity indices if you combine Richemont, Naspers, Prosus and resources stocks—whose prospects are all correlated to China. We are positive about China and our global funds have many good investments there—however, we try to manage concentration risk in the South African Foord Equity Fund by balancing positions across different economic drivers.

As money chases the current winners, it drains out of the previously high-flying 'SA Inc.' companies. We still worry about South Africa's current economic trajectory —but we also see some enticing opportunities at current valuations, especially in the mid-cap sector. Select mid-cap counters trade on price-earnings multiples of less than eight-times earnings with good prospects in all but the most catastrophic scenarios for South Africa.

We are diligently analysing these and other opportunities with a view to making high-conviction, long-term investments. We have already started to do so, creating a platform for excellent real returns from current levels. When the resources run reverses, these robust returns should also translate into meaningful alpha generation for investors compared to the index benchmark.

FOORD IN BRIEF

PRAVARSHAN MURUGASEN APPOINTED HEAD OF EQUITY

We are pleased to communicate the internal appointment of PRAVARSHAN MURUGASEN to the new investment team role of Head of Equity (HoE). The role subsumes some of the key functions of Head of Research (currently held by portfolio manager Nick Balkin) and Deputy Chief Investment Officer (Daryll Owen).

The HoE role will cover management of the equity research process, resources and team; recruitment, development and training of analysts; brokerage management; and management and communication of ESG (Environmental, Social and Governance) investment. These are all areas in which Pravarshan has a natural interest and proven acumen. He has been with Foord since January 2012 and is a chartered accountant, CFA charter holder and holds an MBA from the University of Oxford.

Nick Balkin will relinquish the time-consuming Head of Research role to focus principally on portfolio management and all its related demands. As communicated previously, Daryll Owen will be retiring in the second quarter of 2021 and will immigrate to his wife's ancestral home of Portugal.

MEET THE TEAM 2020

Foord's annual Meet the Team roadshow is a series of events in Durban, Johannesburg and Cape Town. We love that it gives us an opportunity to meet large numbers of direct investors face-to-face to discuss the markets, Foord funds and share our investment thinking.

The realities of the COVID-19 pandemic mean that we must bring the event to you online this year instead. We know that digital meetings are not quite the same, but we hope to still share our current investment thinking. The silver lining is that we can reach a wider audience of investors outside of the main metropoles.

We have provisionally scheduled the presentation for 19 November 2020. Invitations will be sent to all investors soon. We look forward to seeing you online but will record the digital presentation for those who cannot attend the live streamed event. For more information, please contact us on 021 532 6969 or unittrusts@foord.co.za.

MARKETS IN A NUTSHELL

WORLD

EQUITIES

A few giant US tech stocks pushed US bourses to their most expensive levels since the tech bubble in 2000—emerging markets seesawed as high yields, demographics and natural resource endowments simultaneously signalled reward and danger

BONDS

Developed market bond yields hovered at irrational lows on unrelenting central bank stimulus—markets briefly reflected rising inflation risks after the US Federal Reserve changed its policy to target average inflation

CURRENCIES

US dollar weakness should persist—but precious metals and even cryptocurrencies should stay well bid amid growing fiat currency risks

SOUTH AFRICA

EQUITIES

SA equities advanced marginally, led by resources stocks while industrials and financial counters lagged—the managers are cautious despite optically attractive South African equity and listed property valuations

BONDS

The SA government bond yield curve steepened after SARB's repo rate cuts—with the longer end of the curve still availing high real yields under current inflation forecasts

CURRENCIES

The rand was volatile given internal and exogenous shocks but ended slightly stronger against a weaker dollar—emerging market currencies should enjoy tailwinds from material increases in hard currency money supply

COMMODITIES

Precious metals gold and silver rose further on US dollar weakness and continued monetary and fiscal largesse—while Brent crude stabilised around $40/bbl on anaemic demand

ECONOMY

World: Economic activity rebounded after historic second-quarter contraction as lockdowns eased—but recession risks persist given high unemployment, resurgent coronavirus and expiring fiscal stimulus

South Africa: The SA economy contracted a record 16% in the second quarter and unemployment rose by 2.8 million people due to COVID-19 lockdowns—employment recovery will be slow given the dearth of fixed investment opportunities

MONETARY AND FISCAL POLICY

World: Rising sovereign debt levels, pervasive experimental monetary (and now) fiscal policy supported markets—but the US elections, geopolitical tension and second-wave infection rates are material risks

South Africa: Finance Minister Mboweni's supplementary budget stressed the rising risk of a full-blown debt spiral if government does not cut expenditure—given the growth vacuum and growing budgetary share of debt funding costs

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.

A MEMBER OF THE ASSOCIATION FOR SAVINGS & INVESTMENT SA

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

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