FOREWORD

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DID YOU KNOW? FREE FLOAT

The free float is the proportion of a listed company's shares that can practically trade on the stock market. The free float is determined by subtracting from the company's total issued shares those shares considered restricted.

A share is restricted when it is held by investors unlikely to sell in the short term. These shareholders include, for example, company founders, employee share trusts and strategic government or controlling company interests.

Company shares with a larger free float can be bought and sold more readily and are consequently more liquid. Better liquidity can reduce share price volatility in the case of major trading news or significant buying and selling activity.

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BREXIT IMPLICATIONS

The Brexit referendum result signalled the end of 70 years of increasing European integration and unity. WILLIAM FRASER comments on the vote that will change the course of history and the implications for investment portfolios.

The vote for a British exit from the EU highlights a growing global trend: From Brexit to Rome to the popularity of Trump and Sanders, disenfranchised citizens are angrily voting for anti-establishment alternatives. People are expressing the wish to take back their government from the power elite who currently control it.

There are two principal reasons for this trend. Firstly, lower income earners feel abandoned and neglected by their representatives. Falling first world living standards contrast starkly with rising wages in Asian and other emerging market economies that benefited from free trade agreements with wealthy nations.

Secondly, there is growing hostility against the migration of cheaper labour into wealthier economies, being net recipients of lower paying jobs and considerable social benefits. Increased migration has also contributed to a less cohesive national identity, threatening the sovereignty of nations.

The uninspired use of a simple process to manage a complex issue – a ballot with a binary outcome – contrasts with two characteristics we employ when making investment decisions, namely probability-weighted scenarios and management of the risk of loss (see *It's All About The Risk*).

The British in-out referendum was always going to be closely run. Euro-scepticism and hostility to immigration have grown. On a probabilistic basis, the result was never certain. Yet, the appalling economic consequences of "leave" far outweighed the gains from "remain." To remain would imply business as usual. But in the event, the fortunes of the pound, favourable trade agreements, the large UK current account deficit and potential UK ratings downgrade will ignite a long period of uncertainty and opportunity loss.

What does this mean for investors?

Capital markets are set for renewed and potentially brutal volatility, as traders take positions deemed most favourable by the referendum's outcome. UK and EU monetary and fiscal policy is expected to remain highly accommodative to limit the immediate economic fallout, with interest rates staying low or declining further. The political policy response will be to the right.

While we believe there will be little long-term impact on global company earnings, Foord's local and international portfolios will not be immune from the near-term downside volatility, despite the emphasis on quality businesses and conservative portfolio construction. Now is not the time to take unnecessary investment risk in portfolios. The future is uncertain and the tail event risk has intensified. It is therefore paramount to invest in businesses with strong balance sheets, exceptional management teams, diversified earnings streams and good growth potential.

Volatile markets are the ideal time to accumulate quality businesses and position portfolios for the next up-cycle. All of Foord's portfolios have relatively significant cash holdings, which may now be judiciously applied to accumulate preferred investments at lower prices, a scenario for which we have waited patiently. Considerable gold ETF investments in our asset allocation funds provide additional protection and we foresee the probability of a long-run bull market in gold.

Although we will take advantage of the increased volatility, capital preservation remains our primary thesis during these unsettled times. Investors should take special care not to react imprudently by selling into declining markets.

IT'S ALL ABOUT THE RISK

The most undesirable outcome for any investor must be loss from which there is no prospect of recovery. The investment landscape is replete with examples: corporate bankruptcies, bond defaults, rights issues needed to recapitalise failing businesses, dilution from share options, corporate governance failures leading to share suspension or delisting, accounting failures grossly overstating reported earnings numbers, Ponzi schemes and other frauds and many more. As NICK CURTIN explains, investment risk must therefore be defined as the risk of permanent loss of capital.

This contemplation of investment risk is critical when considering portfolio performance relative to a market index or benchmark. While the approach is understandable, the analysis is one dimensional: Almost all widely used market indices are compiled using a free-float market capitalisation weighting methodology (see *Did You Know?*). This means that companies with very large market caps will have large weights in the market index. The construction of such indices considers only a company's size and not the risk of permanent loss associated with an investment in that company. But more on that later.

The active versus passive debate is a subject that has been well aired in the media and is not the main focus of this article. Rather, we aim to emphasise the role of risk management in building investment portfolios as we constantly ask the question, "What if we are wrong in our investment thesis?" Foord's long-term record of investment success shows that by successfully managing the risk of being wrong, we mitigate the risk of permanent capital loss. As a result, it has been possible over longer time periods to generate returns that are significantly in excess of a market index constructed without reference to investment risk.

It is a truism that not every investment idea will pan out exactly as expected — unforeseen situations can arise that fundamentally change a company's prospects and/or valuation. In addition, the fund manager often gets their investment thesis wrong for any number of reasons. There are two principal ways that we manage the risk of being wrong.

The primary mechanism is through diversification, which is the process of including different investments in a portfolio with negative correlations to offset or minimise investment risks. For example, an unexpectedly sudden rise in interest rates would be negative for retail companies but would benefit the banking sector in the short term as a result of the endowment effect. There are many other examples covering variables such as inflation, exchange rates, commodity prices, investor sentiment, economic activity, and the interplay or correlation of such factors with each other. By making sure there are enough diverse drivers of return in the portfolio, we are able to ensure a reasonable outcome, even in those instances when our base investment case turns out to be wrong.

The second key aspect to managing the risk of being wrong is a constituent of diversification, namely position size. Clearly, the potential impact on the total portfolio resulting from a single investment going wrong is directly proportional to the relative size of that investment in the total portfolio. So it stands to reason that we must be extremely vigilant about letting any single position get too big in the portfolio if we are to manage the risk of permanent loss. That said, the more conviction we have in an investment idea, the less diversification we need, which allows us to tolerate fewer stocks of larger position size in the portfolio. Indeed, holding too many stocks in a portfolio has been referred to as "diworsification."

Elroy Dimson, a professor at the London Business School, said, "Risk means more things can happen than will happen." Just because a risk does not eventuate does not mean it was not there and should not have been considered and mitigated. While we cannot control the outcome of events, we can arrange our affairs in such a way that we survive intact should the worst transpire. The typical twin-engine airliner can still take off, fly and land if one engine fails — that is an example of very practical risk management.

And this is where the index comparison starts to get interesting and why there is a very good reason that Foord does not use the market index as a starting point when building portfolios: Because the index is dominated simply by whatever is big, it pays absolutely no attention to the concept of investment risk. Currently, about 25% of the FTSE/JSE All Share Index is comprised of just two companies: Naspers (13.1%) and SABMiller (11.8%). When you add CF Richemont (5.9%), you see that nearly one third of the market index comprises only three companies.

Having 13% of a portfolio in any one investment is, in our opinion, imprudent. If holding a full third of the portfolio in only three businesses results in a "market neutral" position, then, quite frankly, the index construction is sub-optimal. This does not mean we are casting aspersions on the investment prospects of Naspers, SABMiller or Richemont (Foord portfolios are invested in all three businesses and have been for some time). Rather, we hold these shares in proportion to our assessment of fundamental investment risk — position sizes that are significantly lower than those in the market index (see table). The converse is also true: There are a number of holdings in Foord portfolios where position size is significantly larger than that of their index weight simply because they are small, but attractive, businesses.

While most investors are single-mindedly obsessed with performance relative to the index, this is in truth a one-dimensional assessment. When comparing the portfolio to the index portfolio from an investment risk perspective, it is like comparing apples and pears. However, Foord's track record of outperformance shows that, in the long term, the application of sound judgment to portfolio weights while ignoring the index weights results in significantly better performance with lower risk of loss.

MARKET INDEX TOP 10 CONSTITUENTS VS FOORD WEIGHTS

	Market Index[1]	Foord Equity Fund[#]
Naspers "N"	13.1%	5.7%
SABMiller PLC	11.8%	7.6%
CF Richemont SA	5.9%	5.7%
BHP Billiton	5.3%	2.6%
British American Tobacco	3.9%	9.3%
MTN	3.5%	-
Sasol	3.0%	5.0%
Steinhoff International NV	3.0%	8.0%
Anglo American	2.6%	-
Old Mutual PLC	2.5%	-
	54.6%	43.9%

[1] FTSE/JSE All Share Index, J203, 30 June 2016
[#] 30 June 2016

PROSPECTS IN THE ASIAN FINANCIAL SECTOR

Economic commentators have for some time predicted a doomsday scenario for the Chinese economy as its once prodigious growth rates slow. The clamour intensified last year after the Chinese markets dramatically seesawed. KAVITHA MENON explains why we continue to favour Asian financial stocks.

The Chinese authorities are purposefully steering that economy from an investment- to a services-driven model, the hallmark of all developed economies. The transition cannot unfold smoothly and the changing composition and pace of economic growth is creating uncertainty and stock market volatility, coupled as it is with fears of excessive credit expansion.

China's GDP is expected to grow at 6–6.5% per annum over the next three years, down from its double-digit growth in the past decade but well above the global growth rate of only 3–3.5%. Contrary to the doomsayers, we do not anticipate a hard landing, but expect a slow and managed unwinding of China's excess leverage. Unlike most emerging market economies, China's huge foreign exchange reserve stockpile (approximately US$3 trillion) provides a strong buffer against currency and other financial shocks and acts as a margin of safety for investors.

The general pessimism for emerging markets provides opportunities to buy Chinese and Southeast Asian companies with strong earnings growth prospects at attractive valuations and high dividend yields. We like the financial sector, which is driven by a combination of structural and cyclical factors, including low retail credit penetration, strong demographics, rising incomes and supportive monetary policy.

The insurance industry in developing Asia is an underpenetrated market with attractive growth prospects. Insurance premiums as a percentage of regional GDP languishes at 3%, compared to 11% in the more developed Japanese and South Korean markets. Structural economic and demographic trends, rapid urbanisation, increasing wealth and low coverage offered by government sponsored programmes should drive demand for self-provisioning in developing Asian countries including China.

In the property and casualty insurance segment (referred to as "short-term insurance" in South Africa), we are invested in PICC Property & Casualty (PICC). With a 33% market share, the state-controlled PICC dominates the immature Chinese non-life insurance market and could be described as the Santam of China. PICC's low-cost model, surplus capital and strong underwriting capabilities position it to benefit from rising Chinese living standards. We anticipate an increase in insurance premiums, despite the low-growth environment and potential lag in vehicle sales.

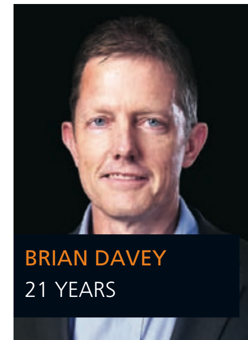
In the life insurance segment, we invest in AIA Group, which is a diversified life insurer with a presence in 18 Asia-Pacific countries. A strong balance sheet, agency-driven business model, best-in-class management and sustainable earnings momentum underpin our positive view on AIA.

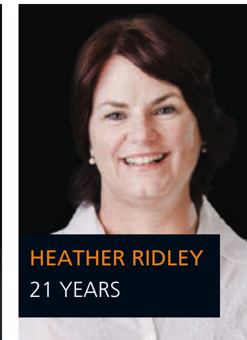
Rising corporate leverage and resultant asset quality issues have affected sentiment towards Chinese banks. But well-capitalised balance sheets and attractive profit generation mean that Chinese banks can absorb higher loan impairments. Moreover, the sector would benefit from government financial support in the event of systemic stress, given the state's substantial participation in the sector.

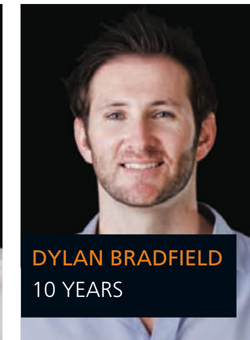
Accommodative monetary policy, regulatory onslaught on shadow banking, proactive measures to address non-performing loans and a gradual lending shift towards better-quality sectors are tailwinds for the banking sector. It also benefits from the ongoing transition to a services-driven economy and we believe current valuations provide a great opportunity for long-term investors.

IN FOR THE LONG TERM

The longevity of the Foord team is among the best in the industry. This year several staff members celebrate significant milestones at Foord. **BRIAN DAVEY** and **HEATHER RIDLEY** have both notched up an impressive 21 years at Foord, while **DYLAN BRADFIELD** and **ARLENE THOMPSON** each celebrate 10 years.


BRIAN DAVEY
21 YEARS


HEATHER RIDLEY
21 YEARS


DYLAN BRADFIELD
10 YEARS

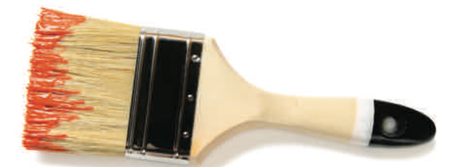
ARLENE THOMPSON
10 YEARS

THE SUM OF IT

Foord has chosen to support educational initiatives that promote the growth of the leaders of tomorrow. Recently, we farewelled a handful of brilliant young maths minds as they embarked on various international maths competitions in Hong Kong and Thailand.

RENOVATION UPDATE

The renovations at our head office in Pinelands are now substantially complete — just in time for winter. Our new space prioritises investors by providing more meeting rooms, which means we hope to see you more often.



MARKETS IN A NUTSHELL

INTERNATIONAL | SOUTH AFRICA

EQUITIES

International: European and UK stock markets suffered heavy dollar losses in the quarter, while the US market outperformed developed market peers – emerging markets were the outperformers, led higher by Brazil, Russia, India and South Africa

South Africa: The JSE eked out a small gain, buoyed by the resources sector, while UK-exposed stocks succumbed post the Brexit vote — financial sector companies reacted negatively to global growth concerns, slowing domestic demand and recalibrated global interest rate expectations

BONDS

International: Developed market bond yields fell further on safe haven demand, with $11 trillion in sovereign bonds now registering negative yields — the global hunt for real yields helped emerging market currencies and bonds in the latter part of the quarter

South Africa: Ratings agencies S&P Global and Fitch Ratings left SA's foreign currency investment grade rating unchanged — but warned that further deterioration of growth prospects and heightened political risks may soon prompt a sub-investment rating downgrade

CURRENCIES

International: Sterling plunged after the Brexit vote to its weakest level in three decades vs the dollar, while the dollar and yen gained on safe haven status — emerging market currencies benefited from recalibrated expectations of the Fed's interest rate path and prospects for more BoE monetary stimulus

South Africa: The rand continued to recover from the shock replacement of then Finance Minister Nene, but the unit remains volatile within a wide trading band — emerging market currencies generally performed well after commodity prices rebounded and on sizable financial markets inflows

COMMODITIES

Gold surged 7% in the quarter on elevated risk aversion and conceivable further expansion of central bank balance sheets — Brent oil increased 23% to end the quarter above $50 per barrel

ECONOMY

International: Britain controversially voted to leave the European Union, ushering in increased uncertainty and heightened market volatility — Britain must exit within two years of triggering Article 50 later this year

South Africa: First quarter SA GDP growth contracted, led lower by weak agriculture and mining production — the SA consumer is under immense pressure, evidenced by weak vehicle sales and credit expansion

MONETARY AND FISCAL POLICY

International: Global economic activity has expanded only very moderately — a disappointing mid-quarter US jobs report and the Brexit vote will have restrained the Federal Reserve from increasing interest rates, given the downside risks to growth and inflation

South Africa: SARB's MPC sensibly left interest rates unchanged on sharply slower private sector consumption growth and rising recession risks — while inflation surprised to the downside allowing the committee to adopt a wait-and-see approach

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*	7.8	-	6.7	0.8
Benchmark	10.1	-	10.6	3.6

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*	16.0	11.0	5.4	0.1
Benchmark	13.8	10.6	6.8	0.5

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*	14.4	14.2	9.7	-0.6
Benchmark	11.4	10.9	11.6	3.8

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*	19.1	13.1	0.7	-0.1
Benchmark	16.3	13.0	3.8	0.4

Benchmark: Total return of the FTSE/JSE All Share Index

FOORD INTERNATIONAL FEEDER FUND

TEMPORARILY CLOSED TO NEW INVESTMENT

Inception date: 1 March 2006

The fund aims to achieve US inflation-beating, long-term returns from a conservatively managed portfolio of international assets, including equities, fixed interest investments, commodities and cash. This is accomplished by direct investment into the Foord International Fund, a UCITS master fund domiciled in Luxembourg.

	Since Inception %	3 Years %	1 Year %	3 Months %
Foord*	13.3	16.5	14.9	-1.8
Benchmark	10.7	15.3	21.8	0.3

Benchmark: US inflation in ZAR

FOORD GLOBAL EQUITY FEEDER FUND

TEMPORARILY CLOSED TO NEW INVESTMENT

Inception date: 2 May 2014

The fund seeks to achieve an optimum risk adjusted total return by investing primarily in a diversified portfolio of global equities, constructed to outperform the return of the MSCI All Country World Index over time. This is attained by direct investment into the Foord Global Equity Fund, a unit trust master fund domiciled in Singapore.

	Since Inception %	3 Years %	1 Year %	3 Months %
Foord*	11.8	-	10.1	-2.9
Benchmark	17.1	-	16.4	1.0

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

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

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