FOREWORD

ISSUE 39 | 3rd QUARTER 2016

DID YOU KNOW? CAP RATES

The capitalisation rate (contracted to the more common "cap rate") is a term borrowed from the commercial real estate industry, but is also used more generally to describe the relationship between asset prices and their yields.

In the real estate industry, the cap rate is the ratio of a property's *net operating income* to its *cost* or *market value*. Typically expressed as a percentage, cap rates can be used to quickly compare a property, or a portfolio of properties, to others. A property with a higher capitalisation rate may be deemed to be trading at a risk premium to one with a lower rate (there could be any number of reasons why this would be so).

Capitalisation rates move inversely to asset values and provide an indication of how quickly an investment would pay for itself. For example, an asset with a capitalisation rate of 5% would be fully capitalised (pay for itself) after 20 years, while an asset with a cap rate of 10% would pay for itself more quickly, over 10 years.

IN THIS ISSUE

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MY WORD IS MY BOND

Investments in government bonds have a traditional place in long-term investment portfolios. Bond securities typically offer an attractive cash interest payment or coupon and safety of principal. WILLIAM FRASER takes a closer look at bonds held in investor portfolios.

Prevailing government bond yields offer useful insight into a country's perceived economic health and the likely direction of inflation and interest rates. A normal growth cycle displays a positive-sloping yield curve, when longer duration bonds offer higher yields than shorter duration bonds. Good economic growth feeds into moderate inflation, solid credit demand and expectations of higher future interest rates. An inverse yield curve, in contrast, describes a contracting economy and expectations of falling interest rates to stem falling investment and consumer demand.

> FOORD HAS CAUTIOUSLY INVESTED IN BONDS OVER THE PAST YEAR.

Unconventional central bank quantitative easing programmes have resulted in artificially low bond yields in the US, Europe and Japan for many years now. Yields in these and other markets are negative when you adjust for inflation. Artificially low capitalisation rates (see *Did You Know?*) have caused bond prices to soar, increasing the future risk of capital loss from this asset class to unacceptable levels, in our view.

South African government bonds, however, still offer positive nominal and real yields in an upward-sloping configuration. These are attractive given the prospects for South African economic contraction and falling inflation in the next 6–9 months, even if interest rates do not decline. In an alternative scenario where growth, inflation and interest rates rise, bonds should still outperform cash. It is on this basis that Foord has cautiously invested in bonds over the past year.

A bond's tenor is the length of time until the bond matures. The tenor captures not only the duration for which a borrower must remain solvent but also the period over which risk factors are in play for bond investors, notably the level of inflation and the path of future short-term interest rates. All things being equal, longer dated bonds with low coupons carry greater investment risk than shorter dated bonds with higher coupons.

The allocation to government bonds in our investors' portfolios reflects the South African government's growing inability to easily repay loan capital over the next 10 years. This risk centres on the structural growth path of the economy, with government revenues set to decline in real terms while its social security programmes must rise, at least with inflation. This will stress government's fiscal position and force it to raise more funding from bond issuances.

In this scenario, it stands to reason that we would prefer to receive as much of the total future return on the bond as early as possible, by means of an attractive annual coupon payment. This is best reflected in the bond's running yield, which is calculated as the bond's coupon divided by its price. We have therefore favoured government bonds with a high running yield and medium tenor, during which time we believe the SA government will remain solvent. The R186 government bond, with a 10.5% coupon and tenor until December 2026, fits the bill.

It is reasonable to assume a gradual deterioration in government finances, benign inflation and accommodative monetary policy. In this scenario, the R186 bond should provide an acceptable real return. However, there is a low probability but possible alternative scenario of structurally higher inflation, higher interest rates and government default. For this reason, we remain cautiously positioned in bonds, in medium tenor instruments with high yields.

THE FUTURE IS NOT WHAT IT USED TO BE

A recent McKinsey Global Institute report[1] advocates that the 30 years ended 2014 were a "golden era" for investment returns and suggests that investors should ready themselves for lower real returns (returns after removing inflation) in the next two decades. PAUL CLUER explains the rationale and repercussions for investors.

McKinsey's sobering message is premised on the fact that the conditions that delivered abnormal long-run returns in the last 30 years are now weakening or even reversing. Indeed, a comparison of multi-decade developed market equity returns seems to support this hypothesis (see Figure 1).

In the US and Western Europe, inflation and interest rates have declined steadily over the past decades. Over this time, global gross domestic product (GDP) growth and corporate profit margins were both above their long-term means, largely attributable to major productivity gains as technologies improved. As interest rates have declined, capitalisation rates (see *Did You Know?*) have fallen and the prices of financial and physical assets have ballooned. Ignoring major market dislocations and financial shocks, the historic price-earnings multiple of the US S&P 500 Index has steadily risen to 25-times trailing reported earnings, also well above its long-term mean. In industry parlance, equity markets are "expensive."

A high-level summary of McKinsey's hypothesis is that interest and inflation rates must rise: Interest rates have persisted at historic lows for almost eight years and are likely to rise with inflation as global economic growth gains traction. As interest rates rise, capitalisation rates will reverse and markets will decline from their current elevated levels. Furthermore, GDP growth as classically measured is likely to be weaker than it has been in the past without further productivity gains and developed market corporate profit margins are likely to be eroded by competition from emerging market companies and new technologies.

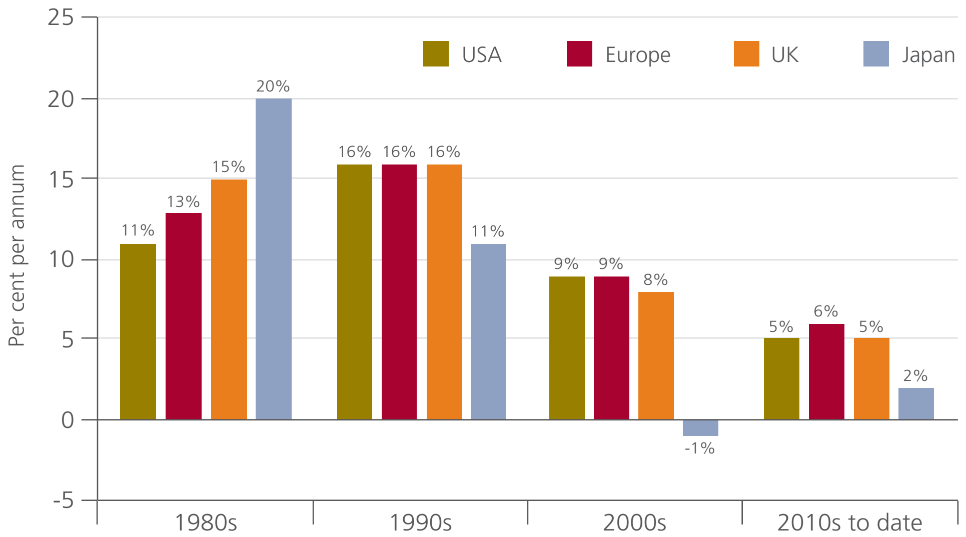
Of some comfort to South African investors (as citizens of a developing economy, rather than a developed one) is that the McKinsey analysis is based on the increased competitiveness and economic activity in emerging markets taken as a whole. Given its unique challenges, these assumptions may not apply to South Africa. Even so, emerging markets will not be immune to the effects of diminished returns in developed markets.

For investors, the consequences of lower real returns are twofold. Firstly, longer investment horizons will be required to reach accumulation goals. Secondly, drawdown rates from accumulated retirement savings must be lower if pensioners' capital is to be preserved for longer in this era of increased longevity. In our view, drawdown rates not exceeding 4% per annum are prudent in the current economic environment. Drawdown rates should be reviewed on a regular basis.

The McKinsey report is useful as it corroborates Foord's own conclusions and expectations for lower future returns, even in South Africa. Further, in the next seven-year cycle, we believe these returns will be asymmetrically earned: They will be especially low in the next two to three years, improving slowly thereafter. Generating inflation-beating investment returns in this future scenario is not impossible, just more difficult. Foord's track record and the conviction levels of its portfolio managers suggest that the company is up to the task. But for now, Foord's portfolio managers are in capital preservation mode.

[1] *Diminishing returns: Why investors may need to lower their expectations*, McKinsey Global Institute, May 2016

Figure 1: **EQUITY RETURNS BY DECADE**



Source: Factset, MSCI regional indicies

CAPITAL PRESERVATION CONUNDRUM

Assume a hypothetical investment yields a 10% return, 60% of the time. 20% of the time, the investment yields zero, while for the remaining 20% of periods, the investment suffers a 50% loss. Given an option of doing nothing with your capital (zero percent return), would you invest your capital accordingly?

The conundrum is interesting because most investors are naturally risk averse and the prospect of any loss is discouraging. That said, the investment delivers an acceptable outcome 80% of the time. Mathematically, the probability-weighted outcome of the investment over long periods is negative: You lose more than you win.[1]

Therefore, true investment stewards would happily sit out of the investment. In the long term, their investors' returns would top the performance tables, but 60% of the time they would lag the peer group with all its attendant, negative consequences.

Foord's 35 years of investment stewardship and absolute-return investment style place it firmly in the camp of investors who would forego the potential upside to focus on capital preservation. We have found that some of the best long-term returns are achieved by avoiding losses, while emphasising the safety of principal and an acceptable long-term return on capital invested.

[1] (60% * 10%) + (20% * 0%) + (20% * -50%) = 6% + 0% - 10% = -4%

WHAT MAKES A QUALITY COMPANY?

As with the concept of beauty being in the eye of the beholder, so might the concept of quality be in the eye of the analyst. In other words, the notion of a quality company means different things to different people. Equity analyst, IRINA SCHULENBURG, looks at Foord's definition of a quality business and why this is important for the long-term investor.

Warren Buffett said, "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price." Provided you don't overpay,[1] wonderful companies will compound your wealth at above average rates year after year.

At Foord, we refer to Buffett's wonderful companies as "quality companies." But what are these companies and what qualities make them so wonderful? Broadly speaking, quality companies possess sustainable competitive advantages that allow them to earn returns well above their cost of capital. They also all exhibit distinct degrees of excellence relative to their competitors.

Michael Porter developed a "five forces" model to analyse the competitive forces within an industry. These factors, namely industry rivalry, bargaining power of suppliers and of buyers and the threats of new entrants and substitutes, can be applied to a company to determine its relative positioning. In addition to these, we examine five additional business-specific attributes to assess a company's quality:

1. Management should be competent and well qualified. We recognise that because people run businesses, management is paramount to the company's strategy, culture and ultimate success. Meritocratic ownership cultures and well-structured cash-based incentive programmes help to deliver long-term shareholder value, with the lowest possible risk.
2. Quality businesses stay focused. It takes years to build a company and its brands, but goodwill can dissipate quickly if management loses focus on client needs, gets distracted by market fads and lets costs balloon. An obsessive focus on their value propositions and cost control translates over time into higher revenue, higher profitability, greater capital velocity and correspondingly better returns on invested capital.
3. Leadership sustains momentum with a proud vision. This aspect is key to retaining talented, creative people. To avoid stagnation, quality companies maintain momentum by making small or sometimes large corrections to their strategic direction. Timing strategic change depends on close attention to consumer demand. Change for the sake of change serves only to destroy brands.
4. Quality companies generate strong free cash flows. Cash is oxygen to a business: You never appreciate how much you really need it until you don't have it. Cash flow is essential to on-going investment as well as to dividend payouts.
5. A strong and disciplined board of directors can be a powerful strategic asset. Good corporate governance ensures that the allure of potential growth does not blind management to common sense and downside risk. It is essential in maintaining balance between the interests of management and minority shareholders.

All quality businesses display these attributes. Identifying a quality business is important because we know that they grow their earnings over the long term at a rate faster than the market as a whole.

Since company share prices ultimately track their underlying earnings' growth, investing in quality companies establishes a good basis for the above-average long-term growth of investors' capital.

[1] Note Buffett did not say "any" price – overpaying for an asset will severely limit future returns.

KING OF THE CASTLE

Chess prodigy and Foord ambassador, Seth-Riley Adams of the Mitchell's Plain Chess Club, tied for first place (U/14) in the African Youth Chess Championship in Port Elizabeth in September. Over the last few years we have seen Seth-Riley mature as a player and as a young man. His commitment to the sport of chess and his achievements are an inspiration to all of us at Foord.

NEW FACE AT FOORD

FAIEKA SLEMMING
ASSISTANT COMPLIANCE OFFICER

FAIEKA SLEMMING has been appointed as the assistant compliance officer to Diane Behr. Faieka was employed for the past 10 years in the internal audit team at a large institutional asset manager and understands the dynamics of the compliance role. She holds B.Com and B.Com Hons degrees from UNISA and the University of Natal.

UNCLAIMED INVESTMENTS

If a distribution or redemption payment is rejected by your bank and Foord is unable to reach you, we may consider your units to be unclaimed. In conformance with industry best practice, Foord will make reasonable attempts to re-establish contact with owners of unclaimed units, which may incur some costs. Unclaimed units will remain invested in the Foord Unit Trust funds until these are either claimed or transferred to another unit trust portfolio on instruction of the Registrar of Collective Investment Schemes.

MARKETS IN A NUTSHELL

INTERNATIONAL

EQUITIES

Markets reacted favourably to the Fed's decision to defer an interest rate increase – emerging markets once again trumping developed markets, led higher by China and Brazil

BONDS

US Treasury yields rose as a rate hike this year became more probable – while Eurozone and UK bond yields fell further following continued BoE and ECB stimulus

CURRENCIES

The dollar weakened against the euro and yen – but the beleaguered pound slumped further as Brexit reality hit home

COMMODITIES

Commodity prices rallied towards the end of the quarter – oil rose more than 7% in September after OPEC agreed to modest production cuts and iron ore found support from increased Chinese demand

ECONOMY

Global growth indicators are signalling accelerating third quarter growth – after a prolonged period of subdued activity, manufacturing PMI numbers have started to improve

MONETARY AND FISCAL POLICY

Monetary policy has remained accommodative, with the US Fed reiterating a mild hiking cycle – while the BoJ and ECB persisted with their quantitative easing and negative rates policies

SOUTH AFRICA

EQUITIES

The FTSE/JSE ALSI recorded a 0.5% gain, with decent returns from resources, banks and Naspers – but non-resource rand hedges were adversely affected by rand strength

BONDS

Bond yields declined across the curve, reflecting improved inflation prospects – an imminent rate cut is unlikely, but there is a high probability that rates have peaked

CURRENCIES

The rand advanced against most currencies as key export commodity prices and general emerging market sentiment improved – assisted by less strident political rhetoric

ECONOMY

Second quarter GDP rebounded to above 3%, lifted by improvements in manufacturing, agriculture and mining – but household consumption growth continued to slow

MONETARY AND FISCAL POLICY

The SA Reserve Bank kept rates on hold – the inflation outlook has improved somewhat while economic activity remains subdued despite robust second quarter growth

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*	7.1	-	6.8	0.0
Benchmark	10.2	-	10.2	2.5

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*	15.7	8.1	6.1	-0.4
Benchmark	13.6	8.2	8.3	0.8

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*	14.1	11.5	11.3	0.7
Benchmark	11.4	11.0	11.3	2.7

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*	18.7	8.9	5.4	0.1
Benchmark	16.1	8.8	6.6	0.5

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

FOORD INTERNATIONAL FEEDER FUND

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*	12.8	13.2	8.5	-1.7
Benchmark	9.8	12.0	0.2	-6.7

Benchmark: US inflation in ZAR

FOORD GLOBAL EQUITY FEEDER FUND

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*	11.4	-	16.0	2.1
Benchmark	14.7	-	11.8	-0.9

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.