CONSEQUENCE
PRIVATE WEALTH

Difficult Investment Conditions Persist: The Value of Retaining a Long-Term Strategic Approach

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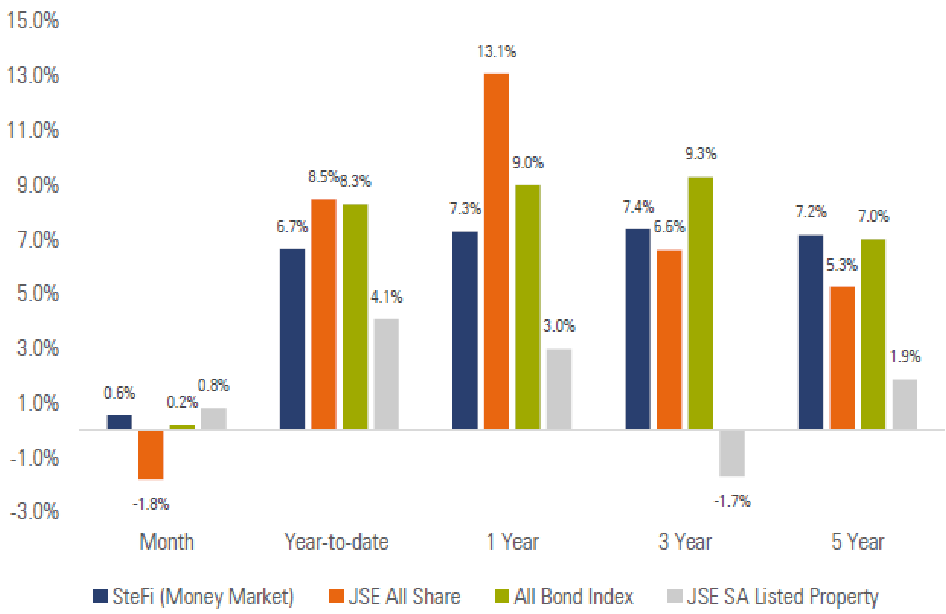
2019 has so far proved to be yet another testing time for investors. Local shares, listed property, and even selected offshore shares, have continued to deliver below long-term benchmarks. This article seeks to reassure clients that we remain fully confident in our investment philosophy and processes. We believe they are robust and capable of meeting and exceeding expectations over time.

A Good November But Still A Tough Year

The last quarter was generally positive for global markets, and even the JSE All Share Index received some welcome respite. Yet the 3- and 5-year numbers for diversified investors with exposure to equity markets continue to lag money market, and for those with listed property exposure the three-year period has been even more disappointing, as Figure 1 below shows.

Figure 1: SA Market Performance (Total Returns)



Source: Morningstar Direct as at 30/11/2019. Returns are in South African Rand and have been annualised for periods longer than 1 year.

Our Results, Our Process

How have our clients fared in these markets? In answering, we would like to revisit our client investment process. Below is a brief summary of the five steps we apply before we invest for clients.

These are categorised as either strategic (long-term positioning) or tactical (shorter term adjustments):

1. ***Personal Circumstances*** *(Strategic)*
   Assessment of age, goals, overall financial position, tax and family estate contexts, income requirements and client appetite for risk.

2. ***Structural Considerations*** *(Strategic)*
   Assessment of most appropriate investment vehicles, such as trusts, retirement funds, unit trust funds and endowments amongst others, to optimise tax and estate planning.

3. ***Nature & Frequency of Investment Contributions*** *(Strategic & Tactical)*
   Is the investment value a once-off lumpsum or series of recurring debits or series of ad-hoc contributions, or combination?

4. ***Macro Environment Context*** (Political/Economic etc) *(Tactical)*

5. ***Positioning of Preferred Investment Instruments*** *(Tactical)*

Steps 1 to 3 define long-term goals and approach. Steps 4 and 5 refine final investment decisions. These tactical elements concerning 'current affairs' are certainly relevant, particularly for lump sum investment values. Ongoing tactical adjustments can also be made considering changing circumstances. We are however careful not to allow 'events' to dominate analysis, as this tends to promote extrapolation of the present into the future, which can lead to missed opportunities.

Balancing Strategy and Tactics for Investors with Fund Blends

A variety of investment instruments are employed for clients; shares, hedge funds, annuities and more, but the predominant route to market for most clients are a selection of quality unit trust funds, placed on online platforms which allow us to easily and cost-effectively invest, sell and switch between funds. The funds provide access to the full range of asset classes such as shares, bonds, listed property and cash both locally and offshore.

Consequence Model Portfolios

To increase our research and fund blending capabilities we partnered with Morningstar Investment Management, a global leader in financial market research, in 2016. We created five model portfolios (Cautious/Balanced/Aggressive/Unconstrained and Tax Free) which best represent our fund blend views, and which are tactically rebalanced at optimal times. We continuously review and refine these models with Morningstar using their in-depth research.

All clients receive unique estate and investment strategies and the Model Portfolios are of course only one option amongst many offered. They are excellent solutions in most circumstances, but some clients prefer an entirely bespoke solution or use the models for specific investments in combination with specific funds or shares. Many of our longer standing clients have portfolios which predate the models and we have only migrated these where appropriate. The models are in place for local rand investments only. Offshore investments are designed on a bespoke fund basis.

Composition & Performance

The models give us the opportunity to present an investment track record, which is obviously impossible for bespoke portfolios which differ between clients. We publish a monthly performance snapshot on our website here and distribute full factsheets on request. Please visit https://consequence.co.za/model-portfolios/ to view them. We can now look back on a 3-year actual record, and back- tested results to include 5-year numbers.

Our **Consequence Aggressive Model**, designed for long term investing compliant within Regulation 28 of the Pensions Funds Act, is a fair comparison benchmark to *Figure 1*. Regulation limits maximum share exposure to 75% and offshore exposure to 30%. The blend is specifically designed to absolutely maximise a long-term aggressive strategy within these confines.

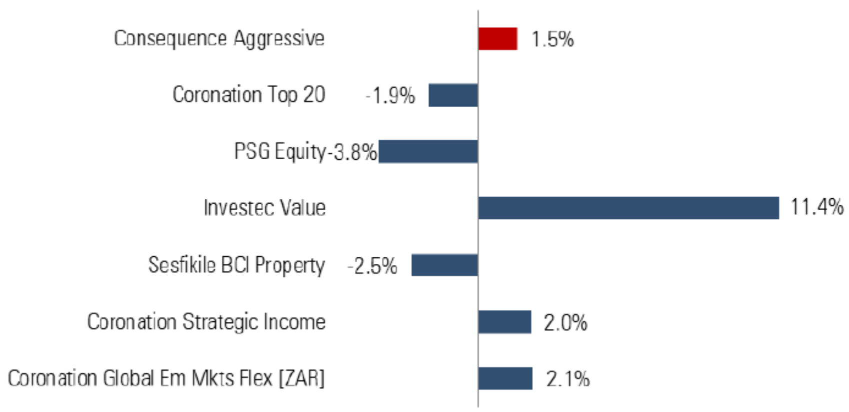
Current Composition:

Coronation Top 20 P	23.00
PSG Equity F	21.00
Coronation Strategic Income P	17.00
Investec Value H	16.00
Allan Gray - Orbis Global Equity FF	11.00
Sesfikile BCI Property B1	7.00
Coronation Global Em Mkts Flex [ZAR] P	5.00

Annualised Performance to End of November:

	1 year	2 years	3 years	5 years
Consequence Aggressive	**11.01**	**-0.43**	**3.99**	**6.31**
SA CPI +5%	8.84	9.59	9.75	10.16
South African MA High Equity	8.86	1.27	4.95	4.74

The underlying fund performance chart below illustrates the diverse set of returns experienced across the blend in the 2nd quarter of 2019, the combination of which resulted in a net positive return:



Comment

- Over 5 years we are ahead of our peer benchmark (the average of all SA Multi Asset High Equity managers) but trailing our own benchmark target of CPI + 5% per annum. Referring to Figure 1, we are ahead of the JSE All Share Index but trail money market and bond averages.

- 1- year performance has been strong, mainly due to the Investec Value Fund. But the same fund is largely responsible for weaker 2- and 3-year numbers, its concentrated and contrarian style leading to high price volatility.

- A notable detractor over three years has been SA Listed Property, a high performing asset class over 20 years but particularly hard hit of late. Earlier this year we introduced the Sesfikile Property Fund to the model.

In summary, we are satisfied that this blend has performed ahead of the market, yet disappointed that we trail our own inflation- plus target. Our clients require those numbers to improve so that expectations in retirement can be met. What are the reasons for these muted returns?

Politics & Markets

Several local shares have slumped due to negative political and economic sentiment. “SA Inc” businesses which rely on local earnings have been hard hit. We believe lower prices for some of these companies are unjustified; several now reflect low price to earnings ratios, pay decent regular dividends, and appear good value. They are well represented in our models. Several of the larger “Rand Hedge” shares have also seen lower prices, but for disparate reasons; Sasol struggling to develop the huge Lake Charles project, British American Tobacco with negative news on vaping. Here too value is appearing.

But is politics the main driving force behind returns over time? Clearly it has a significant effect on SA investor sentiment and we have a realistic view of the challenges faced, but for us the main determinant of returns since the Global Financial Crisis of 2007/2008 has not been politics, but rather the massive interventions of global central banks buying government bonds to inject liquidity into economies. This cannot last forever, and we believe a gradual normalisation of monetary policy will assist our “value” style managers in future.

Value vs. Growth

We favour local and offshore fund managers who adhere more to what is known as a “value” rather than a “growth” style. Value investors prioritise price determination, preferring to buy quality assets only when they are judged to be well priced in relation to metrics such as earnings and dividends, i.e. below fair value. “Growth’ investors favour quality assets exhibiting signs of high growth, even if the share price appears expensive in relation to the same metrics.

We believe the value approach reduces the risk of permanent loss of capital and increases the likelihood of future price gains. This approach has worked before; indeed, it has worked far more often than it has not, as Figure 2 below shows:

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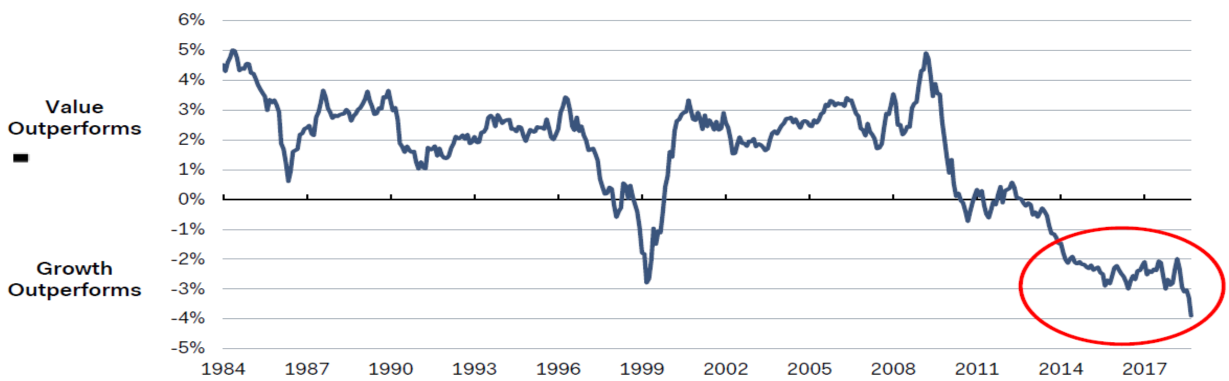
Figure 2: Value vs Growth in Global Equity Markets

1975 – August 2019 Rolling Returns	1-year	3-year	5-year	10-year
% of Periods when Value outperformed Growth	53%	57%	67%	75%

MSCI World Value vs. MSCI World Growth Rolling 10-Year Total Return



Source: MSCI. All returns in USD. Monthly data through August 2019.

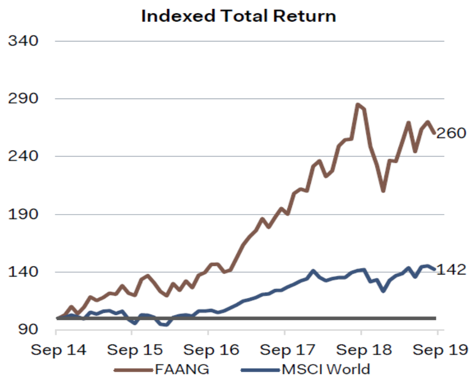
From: The Case for Value Investing, Diana Strandberg, Senior Vice President Dodge & Cox Inc, October 2019

Clearly, longer term value investors are ultimately rewarded, historically. But those ten-year return averages have been moving in favour of growth over value since around 2011. Why?

Why Has Value Underperformed?

In his 2018 article "Where's the Value in Value Investing", Sean Marcowicz, Strategist at Schroders IM, points out that aggressive central bank intervention following the 2007/2008 crisis had the effect of reducing interest rates to historic lows. This, combined with a general scarcity of real corporate earnings growth, plus an appetite for share buybacks, has focused investors on growth shares which are perceived to offer more earnings certainty. That focus has of late been quite specifically on a handful of technology companies, notably the so-called "FAANG" s – Facebook, Apple, Amazon, Netflix and Google (Alphabet).

Figure 3: FAANGS vs MSCI World



forbes.com

Source: MSCI. Five years of monthly data through August 2019. Total Return chart is indexed to August 31, 2014 = 100.

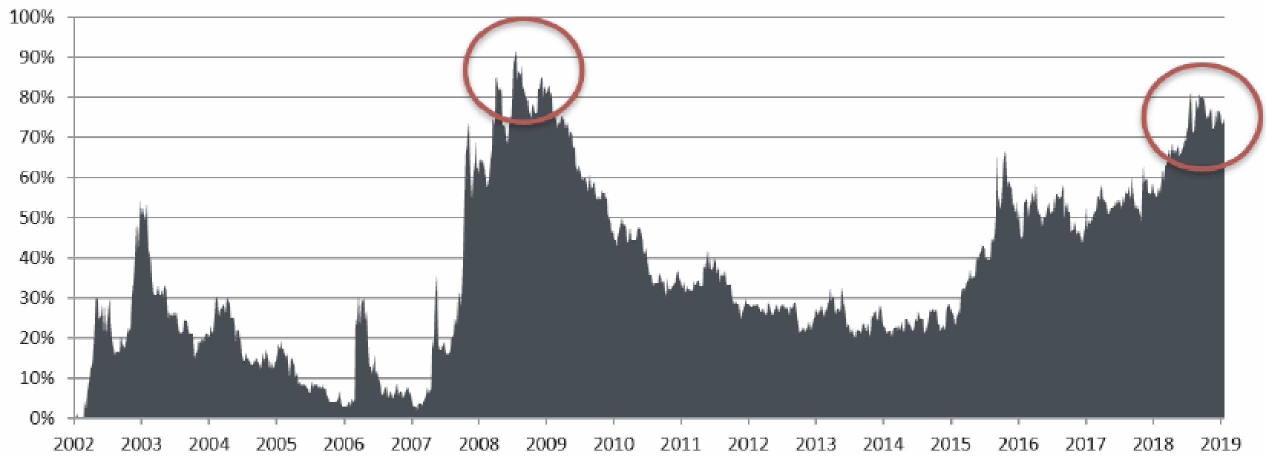
The relentless price appreciation of these companies represents a classic example of the difficult questions value investors must ask themselves; we all recognise these are innovative businesses changing the world. But are they correctly priced now? Do great businesses always equal great investments?

What about the JSE?

In SA too we have seen the strong get stronger. In May 2019, Vuyo Nogantshi, head of Institutional Client Services at Allan Gray, wrote: *"The JSE is also highly concentrated, with the top 10 shares on the FTSE/JSE All Share Index (ALSI) making up between 50% and 60% of the index."*

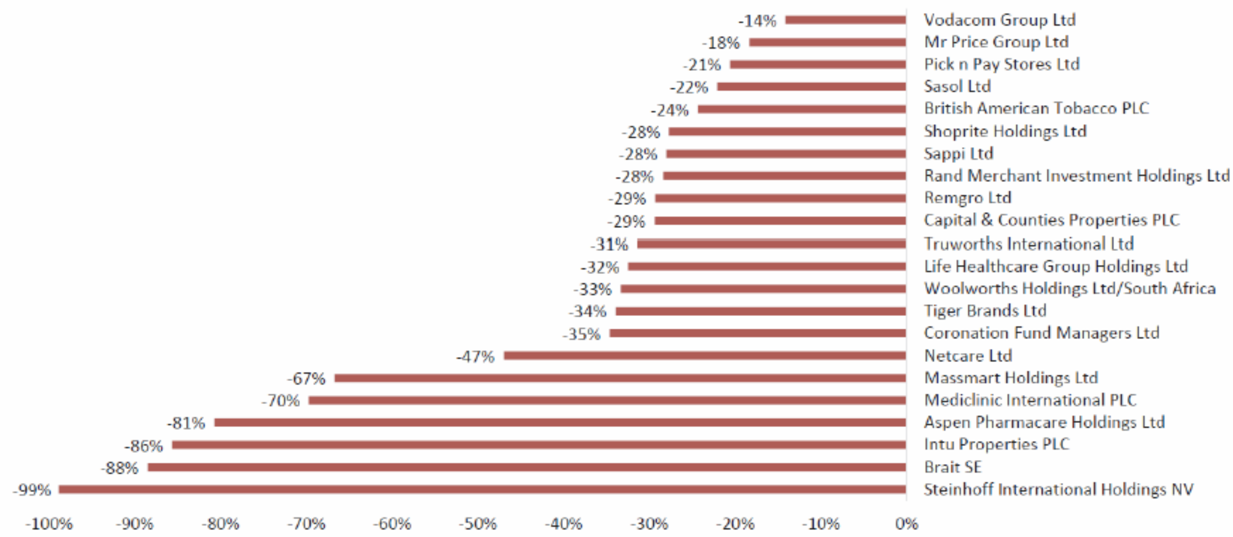
Just as concentrated have been the moderate returns generated in the index over the last few years. The chart below indicates the percentage of shares on the index which are more than 20% off their all-time price highs. 80% of the exchange is essentially in a bear market:

Figure 4: % of JSE Alsi Index More Than 20% Off Price Highs



Source: Bloomberg data as at 30 April 2019, equally weighted

Figure 5: 3 Year Total Returns of Selected JSE Heavyweights to September 2019



Source : Morningstar Direct October 2019

Figure 5 contains some well-known names which have taken a beating. Some, such as Steinhoff, may be on a permanent path out of the index altogether, but there are also quality businesses in there which are now oversold. Taking **PSG Equity Fund** (21% target allocation in Aggressive Model) as an example, their deep value style has clearly been a tough path to walk as they are minus 14.3% over 1 year. But are they now well positioned? We believe so:

Figure 6: PSG Equity Long term price to book now lowest in history of the fund

2020 & Beyond

The JSE itself is at a very low price point historically and that bodes well for future returns from here if previous investment cycles are taken into consideration:

Start Date	3 year subsequent annualized returns
March 1979	16.8%
August 1992	20.4%
December 1998	27.6%
April 2003	40.2%
May 2012	16.4%
Average	24.3%

In summary, our portfolios have generated satisfactory returns in difficult markets, and we believe they are well positioned to do far better as global monetary policy normalises. Patient value investors will then be rewarded once again. We thank our clients for putting trust in us and wish you all the very best for 2020.