



OAM Local Real Return Portfolios
ZAR Rand

JAN 2016

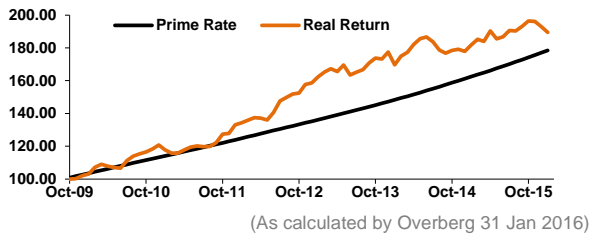
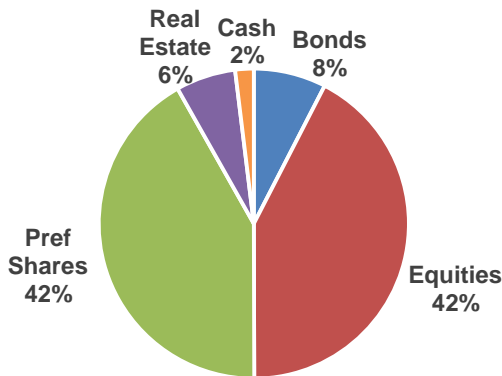
Technical Details

- FSB approved
- Base currency: **South African Rands**
- Minimum investment: **R750 000**
- Benchmark: **Prime Interest Rate**
- Asset Allocation: **Flexible mix of bonds, listed commercial properties, pref shares and ordinary shares.**

Investment Objectives:

- conservative growth with income
- consistent annual real returns
- low volatility

ASSET ALLOCATION



	Real Return %	Benchmark %
Annualised Total Return	10.76	9.71
2010	17.58	11.42
2011	10.14	9.38
2012	19.21	9.11
2013	11.86	8.84
2014	0.26	9.52
2015	8.51	9.83
2016 YTD	-1.85	0.81

*Since March 2005: All performance figures include income and are net of fees and expenses

Growth 2016	Real Return %	Benchmark %
January	-1.85	0.81
February		
March		
April		
May		
June		
July		
August		
September		
October		
November		
December		

		%
Annualised Income Yield		7.46



Introduction

Overberg Asset Management specialises in the management of individual portfolios, tailored to the investment objectives of each client. As an independent company, Overberg can set objective standards in its selection of investments. Privately managed portfolios provide clients with the optimal investment solution. Lower cost structures, greater manoeuvrability and meaningful exposure to smaller companies or tomorrow's "blue chips", all help to generate superior investment returns. Moreover, privately managed portfolios can be tailored specifically to individual requirements. At the cutting edge of investing, Overberg has a proven track record in global and domestic South African markets. Your portfolio will be in the safe custody of Nedbank Private Wealth, Investec Securities or Standard Equities.

Overberg's Real Return Portfolio is an enhanced alternative to either money market funds or bank deposits, offering the prospect of better after tax returns by generating a sizeable portion of income from dividends. Yield is increased by active management across SA government and parastatal bonds, pref shares and growth assets including listed commercial property and high yielding ordinary shares. Valuation volatility is kept at a minimal level with temporary valuation declines not expected to exceed 5% of the value of the portfolio at any point in time. This is achieved through disciplined asset allocation ranges, and diversification across asset classes and individual holdings. A small, actively managed exposure to growth assets will enhance after tax yields with a minimal increase in risk.

Quarterly Commentary 31 January 2016

With the exception of the resources and bank-laden financial sector SA equity markets recovered some of their third quarter (Q3) losses during Q4. Boosted by the large multinational rand hedge stocks the industrial 25 index increased +6.83% during Q3 lifting its gains for 2015 to +15.08%. This was well ahead of the Financial 15 index which lost -3.90% in Q4 and -2.60% for the year. The All Share index eked out a small gain of +1.21 over Q4 and +1.85% for the year, which would have been better if not for the Resources 15 index which extended its woes into the final quarter, losing a further -19.74% extending the year's loss to -39.44%. Rand hedge stocks were the clear outperformers boosted by the dollar's +10.77% gain versus the rand in Q4 alone. For the year as a whole the rand lost -33.86% against the dollar. While the longer dated bonds suffered from the rand's depreciation the All Bond Total Return (1-3 year) index lost only -0.02% in the final quarter and secured a +4.26% increase for the full year. The gold price was one of the casualties of the strong dollar dropping -4.21% in Q4 and -8.39% in the full year from \$1168 to \$1070.

The sharp depreciation in the rand mirrored a troubled final quarter for SA's economy and political stability. A slowing economy, a debilitating drought, declining consumer and business confidence, an interest rate hike, and finally towards the end of the year "Nenegate" with three different Ministers of Finance at the helm of the Treasury in the space of a week. Given this uncertain background the credit rating agencies seem justified in downgrading SA's sovereign debt rating.

GDP grew in Q3 by just 0.7% quarter-on-quarter annualized below the 1.0% consensus forecast. It was hoped there would be a stronger recovery following the unexpected -1.3% contraction in Q2. The main culprits were agriculture which declined -12.6%, mining -9.8%, and the "electricity, gas and water" sector by -8%. Positive contributors were manufacturing which grew 6.2%, the "finance, real estate and business services" sector 2.8%, and the "wholesale, retail and motor trade, catering and accommodation" sector by 2.5%. On a year-on-year basis the economy grew by just 1.5% for the year-to-date, which is disappointing given the low base caused by the strikes in 2014.

Unfortunately the economy is unlikely to rebound from its lethargy. The RMB/BER business confidence index declined from 38 in the third quarter (Q3) to 36 in Q4 well below the 39 consensus forecast increase and the key 50 level which demarcates expansion from contraction. The business confidence index (BCI) declined 15 points since the start of the year to its lowest level in five years. Of the five sectors which make up the BCI, new vehicle



sales fell from 27 to 19, wholesalers from 50 to 47, and building contractors from 45 to 39, while manufacturing remained unchanged at 34. Only retail confidence showed any improvement rising from 34 to 40 although still below the key 50 level.

Among other deteriorating macro-economic indicators the Barclays manufacturing purchasing managers' index (PMI) tumbled from 48.1 in October to 43.3 in November deeper into sub-50 contractionary territory and well below the 48.4 consensus forecast increase. The PMI is at its lowest since August 2009, which is surprising given the boost which had been anticipated in the absence of further load shedding. The decline is attributed to broad-based weakness in domestic demand and policy uncertainty. Among the sub-indices the business activity index fell from 47.7 to 41.4 and the employment index from 44.0 to 40.7. The forward-looking new sales orders index fell from 50.5 to 43.5 and the expected business conditions index to 43.2 signaling a continuation of the weakening trend in the months ahead. At the same time the prices index gained from 73.8 to 75.1 indicating rising inflationary pressure despite the lackluster demand environment.

Despite lowering its GDP forecasts for 2015 and 2016 from 1.5% to 1.4% and from 1.6% to 1.5% and its consumer price inflation peak forecast in the first quarter 2016 from 6.7% to 6.4%, the SA Reserve Bank (SARB) hiked the benchmark repo rate by a further 25 basis during Q4. This marked the second rate hike in 2015 following a similar hike in July, taking the repo rate to 6.25%. SARB Governor Lesetja Kganyago acknowledged that economic prospects remain weak but cautioned against the second-round effects on inflation from a weaker rand and rising wages.

In spite of the sharply weaker rand the trade balance registered a massive –R21.4 billion deficit in October markedly higher than the –R7.8 billion consensus forecast. Exports contracted -6.0% month-on-month while imports increased 15.7% driven by a 19.2% increase in imports of machinery and electronics and 45.1% jump in transport equipment imports. Following months of improving trade data the latest reversal is disappointing given the beneficial effect of the weakening rand on the country's terms of trade. The trade data suggests the rand's depreciation is still not sufficient to compensate for the rapid decline in global commodity prices.

Surprisingly growth in private sector credit extension (PSCE) accelerated from 8.4% year-on-year in September to 8.9% in October beating the 8.5% consensus forecast, with improvements in credit extension to both companies and households. Although stronger credit extension is encouraging the recent jump is unlikely to build momentum due to persistently weak business and consumer confidence, high levels of household indebtedness, weak employment prospects and rising interest rates. The same forces are crimping retail sales growth which on a quarter-on-quarter basis increased in Q3 by just 1.0%.

As anticipated Fitch credit rating agency downgraded SA's sovereign foreign currency debt rating from BBB to BBB- just one notch above speculative grade or "junk status". The downgrade had been expected bringing the Fitch rating in line with the rating of Moody's and Standard & Poor's. Of greater concern, Standard & Poor's (S&P) in its biannual credit review replaced its "stable" outlook for SA's credit rating with a "negative watch." A negative watch normally precedes an actual downgrade and in this instance paves the way for a downgrade to speculative grade or "junk" status. S&P warned that the next rating is likely to be speculative grade unless, according to S&P: "We observe policy implementation leading to improved business confidence and increasing private sector investment, and ultimately contributing to higher GDP growth."

A downgrade to speculative grade would affect government borrowing costs, lead to capital flight and currency weakness. Due to mandate restrictions most foreign investors will withdraw funds from SA in the absence of an investment grade rating making it harder for the country to fund its large current account deficit. With foreign investors owning around 40% of outstanding rand denominated government bonds (up from 14% in 2009), and a majority stake in almost half the JSE's top 40 stocks, the volume of foreign disinvestment resulting from a rating downgrade could be massive. The consequences for the rand and interest rates would be crippling. SA had a speculative grade rating in 1994 but understandably at this stage, so soon after years of economic sanctions, there was very little foreign ownership of either domestic bonds or equities. As a result the amount of foreign disinvestment which ensued was negligible. This time may be different.



There was some positive news during the quarter. The Medium Term Budget Policy Statement kept state finances on a fiscally prudent course. Although the budget deficit to GDP ratio falls more gradually than previously expected to 3.3% in 2016/17 and 3.2% in 2017/18 compared with earlier forecasts of 2.6% and 2.5% this year's budget is expected to be 3.8% of GDP down slightly from the Treasury's 3.9% forecast in February. Load shedding has also reduced substantially and in its quarterly system update Eskom's CEO Brian Molefe reiterated that the state energy utility should be able to avoid load shedding through the summer months. Despite prevailing political and economic uncertainty and investor concerns it is also worth remembering that some of SA's institutions remain world-class. The 2015 Open Budget Survey which measures countries according to their budget transparency ranked SA third out of 109 countries just behind New Zealand and Sweden.

Unfortunately the current environment appears overshadowed by bad news and bond yield spreads indicate a strong likelihood that SA will lose its investment grade rating by mid-year. Slower GDP growth goes hand-in-hand with declining corporate earnings growth, which accompanied by prospects of rising interest rates makes it difficult to justify the current level of the JSE All Share index. SA equities trade on a trailing price-earnings multiple of 18.3x which is not only significantly above the 12x emerging market average but also above all developed markets, as well as its own 14.3x long-term historic average. This would be warranted if companies and the economy were exhibiting above-average growth rates but this is currently not the case. Foreign investors have been net sellers of hefty quantities of equities in the past three months. The increased selling by foreigners lifts the chances of a market correction. Fortunately our portfolios remain defensive with significant rand hedge weightings and substantial cash holdings to protect investors from further rand depreciation and the likelihood of equity market consolidation. We have identified attractive potential investments which will be purchased once valuations becoming more compelling.