

## OAM Local Real Return Portfolios ZAR Rand

NOV 2013

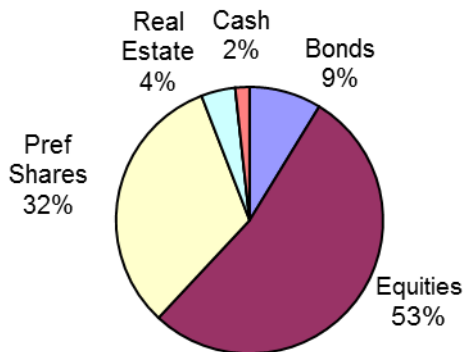
### Technical Details

- FSB approved
- Base currency: **South African Rands**
- Minimum investment: **R500 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 %
<b>Annualised Total Return</b>	14.39	9.74
<b>2010</b>	17.58	11.42
<b>2011</b>	10.14	9.38
<b>2012</b>	19.21	9.11
<b>2013 YTD</b>	9.16	8.07

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

Growth 2013	Real Return %	Benchmark %
January	2.34	0.71
February	1.84	0.71
March	1.21	0.71
April	-1.03	0.71
May	2.43	0.71
June	-3.64	0.71
July	1.04	0.71
August	0.98	0.71
September	2.44	0.71
October	1.70	0.71
November	-0.34	0.71
December		

	%
<b>Annualised Income Yield</b>	9.46

### 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 maneuverability 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 30 September 2013

Like most equity markets around the world, SA equities celebrated the US Fed's surprise decision to delay tapering its quantitative easing (QE) program. Equity markets also enjoyed the rebound in 2<sup>nd</sup> quarter (Q2) GDP figures. As is often the case, the Resource 10 index outperformed in a strongly rising market, with a gain of 16.50% over the 3<sup>rd</sup> quarter (Q3). The Industrial 25 also gained strongly by 10.34%, followed by the Financial 15 with 6.23%. The All Share index was up by 10.51%. For the year-to-date (YTD), however, the Resources 10 remained the clear underperformer with a loss of -2.51%. The outlier was the Industrial 25 with a gain of 26.25%, powered by the big-3 (Richemont, Naspers and SAB Miller) with the Financial 15 and All Share index posting relatively muted gains of 8.16% and 12.18%. The Fed's surprise decision offered some respite to emerging market currencies with the rand only depreciating against the US dollar by -0.40% over the quarter, although still -16.23% YTD. Bonds followed suit, the All Bond Total Return index (1-3 year) gaining a robust 11.23% over the quarter, and 12.16% YTD. The dollar gold price also benefitted from the Fed's inaction, gaining 11.23% over the quarter, but still down YTD a hefty -20.63%.

Although GDP growth accelerated to an annualised rate of 3.0% in Q2, this came off a low base of just 0.9% growth in Q1. Most of the improvement was due to a rebound in manufacturing output, up 11.5% on the quarter after contracting -7.9% in Q1. Agricultural output fell -3.7% and mining contracted -5.6% in spite of normalization after last year's paralyzing strikes. Construction activity remained weak with output up only 1.2%. Industries relying on consumer spending fared better with the "wholesale, retail and motor trade, catering and accommodation" category increasing output by 3.2%, up from 1.9% in Q1. Similarly the "finance, real estate, and business services" sector grew 3.5%, up from 3.3%. For several quarters consumer related sectors have filled the gap left by the productive engines of the economy. However, this support may be difficult to maintain. Consumers are under increasing financial pressure from rising prices of essential goods and services, uncertain employment opportunities, high debt levels,

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and tightening lending standards. The Reserve Bank's September Quarterly Bulletin shows annualised growth in domestic spending slowed from 3.5% in Q1 to 2.7% in Q2. The only bright spot is the improvement in capital expenditure by the private sector, which picked up to 4.4% from a very modest 2.8% in Q1.

Overall the economy grew by a moderate 2% on the year in the 1<sup>st</sup> half of 2013 and so far there is little to suggest any pick-up in Q3. The slump in the mining sector continued in July, with output up only 0.5% on the year, despite the low base. While the manufacturing sector rebounded, with production up 5.4%, the Kagiso purchasing managers' index (PMI), a key indicator of manufacturing conditions, suggests a short-lived rebound. The PMI fell sharply from 56.5 in August to 49.1 in September, below the key 50 benchmark that demarcates expansion from contraction. Circumstances have once again taken a turn for the worse, with production threatened by waves of strike action. Workers in the automotive manufacturing industry went on a week-long strike from 19<sup>th</sup> August, which then continued throughout September, while in the mining industry further strikes afflicted the gold and platinum sectors.

The balance of payments remains weak. Wider trade and service deficits pushed the current account deficit from 5.8% of GDP in Q1 to 6.5% in Q2. The weaker trade performance continued in Q3, causing the trade deficit to rise from R13.4 billion in July to R19.1 billion in August. The cumulative trade deficit for the YTD increased to R110 billion from R69 billion over the same period last year. Unfortunately, the weaker rand may not provide the expected boost to exports, given the tepid demand from key export markets such as the Eurozone. Meanwhile domestic factors are undermining production and price competitiveness, including strike activity, high electricity tariffs, rising unit labour costs, expensive transport and logistics, as well as renewed legislative uncertainty. At the same time imports may not decline as expected due to the anticipated recovery in infrastructure investment by public corporations and the associated demand for imported capital goods.

The current account deficit is likely to remain above 6% of GDP over the next 3 years. Financing the deficit has already become more challenging since Q2. Net portfolio outflows from emerging markets are likely to accelerate again when the Fed does eventually normalize its monetary policy. Countries such as SA, characterized by current account and fiscal deficits, structural growth impediments, and relatively high inflation are especially vulnerable. Recent government policy does not help in fostering foreign investor confidence. Government adopted the "Basic Conditions of Employment Amendment Bill" in late June and the contentious "Labour Relations Amendment Bill" in late August, both adding to the inflexibility of labour legislation. At the same time government has proposed amendments to the "Minerals and Petroleum Resources Development Act", which threaten security of tenure. The amendments would give the government almost unfettered discretion in declaring minerals "strategic" for local beneficiation, and further undermine transparency in mineral rights applications.

Headline consumer price inflation (CPI) remained above the SA Reserve Bank's (SARB) 3-6% target range in August, edging up slightly to 6.4% from 6.3% in July. The rise is attributed to higher housing and utility costs, the jump in fuel and energy prices, as well as rising food prices. Although the SARB indicated that August probably marked the peak in inflation, a vulnerable rand remains the key risk to inflation over the short-term. The tone of the latest policy meeting seemed less accommodative than usual with the SARB raising its 2014 CPI forecast from 5.5% to 5.8%, and for 2015 from 5.2% to 5.4%. The SARB now stands almost alone among emerging economies in not tightening monetary policy in response to currency depreciation. SA's real interest rates (nominal interest rates less inflation) remain extremely accommodative and firmly in negative territory. Currently the Forward Rate Agreement (FRA) market is pricing in a 30%

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chance of a 50 basis point interest rate hike in 3 months' time. The probability rises to over 120% over 6 months and even higher beyond that, indicating that the market is not only anticipating a hike but rather the return of a full monetary tightening cycle. The SARB commented that they will not hesitate to act if CPI forecast deteriorate significantly.

Despite better Q2 GDP figures the economy remains fragile with significant downside risks. Consumers are financially more vulnerable and generally wary of spending. Meanwhile, an unfavourable economic, labour and policy environment continues to undermine business confidence, constraining investment and limiting employment. Financing the current account and budget deficits are likely to become harder and more expensive, adding further pressure on the rand. Ironically it is these headwinds and the impact on the rand that have contributed the bulk of this year's gains in the All Share index. The index has largely been propelled by rand hedge stocks, such as the big-3, which due to the protection they provide against currency depreciation, have been re-rated to extremely lofty levels. Notwithstanding the particular attraction of rand hedge stocks, and the pricing-in of growth potential from the African continent, we feel that SA equities are becoming expensive with the All Share index trading on an estimated 17x forward price-to-earnings multiple. As a result of high valuations and the difficult economic environment we will look for opportunities to make the portfolios more defensive over the coming quarter.