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KEY TAKEOUTS:

• FED ALLAYS FEARS OF AN AGGRESSIVE HIKING CYCLE
• GLOBAL GROWTH SLUGGISH, BUT STABLE
• EMERGING MARKETS ENJOY SOFTER US DOLLAR
The past month was largely characterised by a heavy focus on the policy intentions of the US Federal Reserve (the Fed), causing considerable volatility in the US and in global equity markets. In the event, the US S&P 500 Index ended September pretty much unchanged compared with the end of August, with the sell-off earlier in the month being followed by a strong rebound.

The early sell-off was caused by dented risk appetite as a number of Fed officials indicated that macroeconomic conditions supported another hike in the Fed Funds rate over the next few months. These comments were supported by a sustained expansion of the US economy, albeit relatively pedestrian; data confirmation that the labour market remains tight; and an upside surprise in inflation for the month of August. While consensus expectations were pretty unanimous that the Fed would not raise rates at the end of its two-day meeting on 21 September, markets strongly concluded from pre-meeting Fed comments that an interest rate hike before year-end was still likely. Furthermore, it raised some concerns over the Fed’s policy intentions through 2017. This caused a wave of risk-off sentiment, causing the sell-off of a cumulative 3% in the early part of September.

As expected, the Fed left rates unchanged and actually delivered a positive surprise to markets as the median forecast of the individual Federal Open Market Committee (FOMC) members’ perceived path for the Fed Funds rate through 2018 was substantially lowered. This allayed market fears that the expected hike before year-end would mark the start of a much more aggressive hiking cycle by the Fed. The current median forecast indicates only two 25 basis point hikes in 2017, about half the previous median forecast. On the back of this news, markets rallied quite strongly, wiping out the earlier losses.

**GLOBAL GROWTH SLOW, BUT STEADY**

Incoming data during September did not reflect any material change to the broad global macroeconomic environment that has been in place so far this year. The most positive comment is probably that global growth appears to be stable, albeit still very slow – with China showing more signs that policy stimulus over the past year has stabilised the growth pace (although there is not yet any convincing signs of a meaningful acceleration).

Emerging markets, and commodity producers in particular, continue to enjoy easier conditions, brought about by a moderately softer US dollar, somewhat higher commodity prices and a still relatively favourable financing environment.

**LOOKING INTO 2017**

We remain of the opinion that global growth will improve moderately, as monetary policy stimulus gains a bit more traction. The outlook will decidedly improve further should the much-debated need for global fiscal stimulus actually materialise.
KEY TAKEOUTS:

• NO MAJOR MACROECONOMIC DATA SURPRISES
• CURRENT ACCOUNT HEALTHIER, BUT STILL TENUOUS
• SARB SETS HIGH BAR FOR RATE CUT
INTEREST RATES LIKELY PEAKED, BUT NO CUTS IN SIGHT

RIAN LE ROUX | CHIEF ECONOMIST

Locally, September was relatively quiet as concerns over the position of the Finance Minister faded a bit and macroeconomic data did not yield any major surprises. This was certainly welcome, following the past few months of high levels of concern over politics and concerns over the overall state of the economy.

On the back of a lack of any meaningful “bad news” during September, the rand firmed notably, trading below R14.00/US$ as September drew to a close.

On the macroeconomic front, the release of the South African Reserve Bank (SARB)’s Quarterly Bulletin confirmed the narrowing of the current account deficit to 3.2% of GDP in the second quarter, from 5.3% in the first quarter. Although the narrowing was welcome, and was driven by a notable improvement in the balance on SA’s physical trade with the rest of the world, it was less than the consensus view (as the hoped-for improvement in the deficit on the services account failed to materialise). In this regard, the sharp decline in income on SA’s investments from abroad over the past several quarters did not improve as was anticipated. Moreover, while the second-quarter deficit was much smaller than the deficit in the first quarter, the average for the first half of the year was 4.3% of GDP, exactly the same as the deficit recorded in all of 2015. This implies that a good second-half physical trade performance is required to confirm that our structurally large current account deficit has finally started to narrow.

INFLATION STAYS IN CHECK

Inflation also remains reasonably well contained, despite still being stuck at the top end of the SARB’s inflation target range. Still, over the past few months, inflation has generally surprised on the downside by not rising as much as was generally expected. As we said last month, we remain confident that the cyclical peak in inflation is behind us, namely the 7.0% recorded in February this year. The recently firmer rand, declining grain prices and stable oil price strengthen our view that, despite a likely rise in inflation over the next several months for “base effect” reasons, inflation should drift lower later this year and through 2017.

SARB SETS A HIGH BAR FOR RATE CUT

The best piece of news over the past month came from the SARB itself, as the Bank indicated that, on the back of the improved inflation outlook, interest rates may be close to, or already at, the peak in the cycle. We have held the view for some months now that the SARB will not raise rates again in this cycle, barring an unexpected renewed slump of the rand. While the peak in the rate cycle may indeed have been reached, the Bank indicated that the bar for a rate cut is high. Lower rates will only be possible if and when inflation falls convincingly into the inflation target range, and inflation expectations follow. This implies that rates are unlikely to be lowered before deep into 2017, unless inflation surprises notably on the downside earlier.

Despite some positive developments on the financial side of the economy, the real economy continues to struggle. While
the solid 3.3% annualised expansion in GDP in the second quarter was indeed welcome, early data for the third quarter indicates that this has not been sustained – although it is still very early and much can change. Still, it is difficult to see what will sustain a strong growth pace in the second half of the year, as consumers remain under considerable financial pressure, private fixed investment is contracting on account of deeply depressed confidence and weak demand, and government consumption is only growing slowly as the spending ceiling imposed by National Treasury is doing its job in containing the fiscal situation.

In summary, while headline macroeconomic news was generally reasonably good over the past two months, developments in the political sphere remain a major concern, not only to the ratings reviews due out at the end of the year, but also to the already deeply depressed consumer and business confidence. Without a major turnaround in both, a sustained economic recovery will be difficult, if not impossible, to achieve.

As I said last month, the bottom line is that, despite some rays of economic sunshine appearing over the past few months, very dark clouds remain in place over prospects for the remainder of 2016 and 2017, and even beyond.
RESOURCES
PENDING US RATE HIKE DULLS PRECIOUS METALS
The basic materials sector continued to perform well during the third quarter of 2016, rising 8.1% as opposed to the FTSE/JSE All Share Index’s rise of 0.6%. For once, the gold sector was the main laggard, falling 10.0% over the quarter, while the platinum and general mining sectors were the standout performers, rising 22.6% and 16.7%, respectively.
Sasol [in the chemicals sector] continued to underperform despite a relatively strong oil price, as the strong rand and concerns about its US investment policy continued to weigh on share price sentiment.
For the first time this year, commodity prices appeared to start to follow their own fundamentals, rather than just all following each other. Coal prices were the stand-out performer as China committed to a policy of reducing supply, with some of the base metals, zinc and nickel in particular, also appreciating due to favourable news on the supply side. Iron ore started to come off, albeit not as fast as most commentators were expecting, while manganese ore prices stayed very strong. Probably the worst performer, as a group, would be the precious metals segment. Despite not raising rates, the US Fed gave enough indications that there would be one more hike this year, and this appeared to put the dampeners on the gold price. Despite differing fundamentals, the platinum price followed it down, falling below US$1 000/oz just after the quarter.
Following the bloodbath seen in commodities over the past three years, some calm appears to have returned to the scene. Strategies have evolved from the standard “push production to cut unit costs” to a more nuanced approach, where loss-making capacity is cut and operations are reduced in scale. This has multiple benefits for the corporations, although obviously less for the workers. Chief among the benefits is that the supply to the market has at last started to slow. The industry is now in leaner, more sustainable shape than it has been for most of this decade.
Despite the strong year so far, some stronger economic data is probably required to enable continued outperformance. Commodity prices are still largely tied to improving demand in the main markets, namely China, the EU and the US – all of which are probably growing a little less than what would be ideal for markets. There is a concern that the Chinese property sector, which has led the commodities sector so far this year, could be reined in slightly by the authorities to stop the formation of any “bubbles”. Strong balance sheets and/or the ability to continue generating cash in current conditions remains an important consideration in determining value. The industry is still in a period of restraint, but the recent share price surge has at least improved the atmosphere surrounding the sector.

INDUSTRIALS
SENTIMENT LOW AMID GROWTH CONCERNS
Globally, economic activity was buoyant in the US, while China continued to pick up. Resources companies continued to bounce off their lows and stock markets in emerging markets improved. In South Africa, various political events, dominated by the uncertainty of the status of the investigation by the Hawks of Finance Minister Pravin Gordhan, led to further volatility in the markets over the period. The FTSE/JSE All Share Index (ALSI) returned 0.6% during the third quarter to the end of September 2016, with industrials down 1.9%, while the rand strengthened against the US dollar by 6.1%. Despite the volatility in the market, there were still some opportunities to make money during the quarter.
After years of underperformance, shares in the construction sector performed well, with Aveng, Afrimat and Group 5 returning 96%, 39% and 36%, respectively. However, there is no clear fundamental good news story developing in the South African construction landscape, as operators in that sector are trading on very thin margins and, in some cases, are loss-making. The outlook has not changed in this regard either, so we view these share price movements as being indicative of recovering from very oversold positions rather than a fundamental change in prospects for the sector.
Poor returns were seen from Mr Price (26%), Adcorp (25%) and Mediclinic (22%). There is no discernible “theme” from shares delivering poor returns as each company in that list has various company-specific issues that they are dealing with. Mr Price’s recent trading update surprised on the downside and highlighted that the consumer might be weaker than the market expected. On average, consumer and business sentiment remains low. Looking into the rest of the year, the overhang of the outcome of a possible sovereign downgrade by ratings agency Standard & Poor’s in December will be important going forward. Recent meetings with various managers of JSE-listed firms reveal a worrying picture for growth in the year ahead.
The trailing price:earnings (p:e) ratio of the Industrial Index continues to trade at a high level of greater than 20 times and well above the 10-year average of 17.9 times. This does include highly rated Naspers, which has a large weighting in the Index. Against a backdrop of “high” valuation levels, fragile local fundamentals, and a volatile stock market and rand, we continue to favour high quality companies that are defensive, with at least some offshore currency exposure.
FINANCIALS

BANKS LEAD, GENERAL FINANCIALS LAG

Uncertainty and volatility remained a dominant theme during the third quarter of 2016. Political risks receded as tensions reduced towards the end of the quarter, the rand firmed and bond yields fell as inflation remained fairly contained. This provided some stability amidst volatility and positively impacted the financial sector and the banks, in particular. That said, we continue to exercise caution as the chance of a sovereign downgrade towards the end of the year remains.

The FTSE/JSE Financial Index returned 0.8% over the third quarter, an improvement on the -4.3% return of quarter two. The Index has outperformed the FTSE/JSE Shareholder Weighted All Share Index (SWIX), which rose 0.3% over the same period.

It was a tale of two cities for the performance within the subsectors. The only two sectors with positive quarterly returns were the banks, regaining lost ground to deliver a return of 10%, and non-life insurance with a 2.5% return over the quarter. The other sectors all had negative returns, ranging from -1.5% for life insurance to -6.2% for general financials.

Amidst high levels of political and economic uncertainty, the banks all delivered satisfactory first-half results, which supported a rally in the sector off very low valuations. Nedbank surprised positively as credit quality improved in a challenging environment – confirming a measure of conservatism by the management team. Underperforming companies are a consequence of continued uncertainty over Brexit and its impact going forward – especially impacting Investec and its UK banking operation.

It is a tough operating environment for financial companies, characterised by soft SA gross domestic product (GDP) growth and risks of higher bond yields. Consumer debt levels remain high, as interest rates have risen modestly to counter against the threat of higher inflation. The risk of a looming sovereign downgrade remains. Within this context, we prefer companies that have strong operating metrics and that are well capitalised.

LISTED PROPERTY

DISTRIBUTION GROWTH LIKELY TO SLOW

The SA Listed Property (SAPY) Index delivered a total return of -0.7% in the third quarter of 2016. Over this period, property underperformed the FTSE/JSE All Share Index (+0.6%) and significantly underperformed the JSE All Bond Index (+3.4%). It outperformed general retailers (-7.7%). Listed property’s yield gap with bonds widened, making it materially cheaper than bonds.

Over the past 12-months, listed property’s total return was +3.8%, against the All Share Index’s +6.8% and the All Bond Index’s +7.7%. The quarterly results were dominated by the stronger companies: average distribution growth was comfortably in the double digits and no local REIT reported dividend growth of less than 6%. Most achieved or exceeded expectations, despite a troubled economy. That said, the sector’s distribution growth rate should slow going forward. This is because the rate of dividend growth has been unsustainably high, the economic environment has not improved and the stronger rand reduces the rand value of foreign earnings.

The SAPY has a 6.9% forward dividend yield (excluding non-dividend payers Attacq and Pivotal) compared to 8.5% on the 10-year bond.

Near-term distribution growth should exceed inflation. Vacancies may still increase in some sectors. A genuine recovery in conditions may take longer than many anticipate, with disappointing GDP growth, cost increases constraining net rental growth; and significant over-rentals on renewal in some pockets (our key concern, especially in offices also faced with significant potential new supply). Large malls remain robust, but oversupply in some nodes and tenant and medium-term consumer health are a concern. Bond yields are the key short-term driver of capital value volatility.

MARKET INDICES 1 OCTOBER 2015 – 30 SEPTEMBER 2016

<table>
<thead>
<tr>
<th>Index</th>
<th>Return</th>
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<tbody>
<tr>
<td>FTSE/JSE All Share Index (ALSI)</td>
<td>6.8%</td>
</tr>
<tr>
<td>FTSE/JSE Shareholder Weighted All Share Index (SWIX)</td>
<td>9.2%</td>
</tr>
<tr>
<td>FTSE/JSE Financial Index</td>
<td>-0.9%</td>
</tr>
<tr>
<td>FTSE/JSE All Share Industrial Index</td>
<td>4.7%</td>
</tr>
<tr>
<td>FTSE/JSE All Share Resources Index</td>
<td>24.1%</td>
</tr>
<tr>
<td>FTSE/JSE SA Listed Property Index (SAPY)</td>
<td>3.8%</td>
</tr>
</tbody>
</table>

Source for figures: Deutsche Securities
KEY TAKEOUTS:

• LOW GROWTH AND DISINFLATION DEFINE GLOBAL CONDITIONS
• FOREIGN INVESTORS HUNGRY FOR RISK
• CURRENCY SWINGS A RISK FOR INFLATION
• OUR FOCUS IS ON CAPITAL PRESERVATION
In terms of the global macro-economic backdrop, not much has changed over the past quarter or so in terms of the broader global trend of low growth and disinflation – except that the US labour market continued consolidating gains. With a US unemployment rate around 5% and the more stable core inflation rate hovering above 2%, we remain of the view that this combination is close enough to “norm” to enable the US Federal Reserve to proceed with the slow normalisation of monetary policy. Therefore, the decision by the Federal Open Market Committee (FOMC) at its most recent meeting to, yet again, defer raising rates, was disappointing.

Elsewhere, the Bank of Japan announced tweaks to its quantitative easing programme, acknowledging the potentially unintended disruptive consequences of ongoing unconventional policy measures.

FOREIGNERS’ INSATIABLE APPETITE

Meanwhile, the dusty stampede of global investors, especially from developed economies, into higher-yielding emerging market assets remains relentless. As a result, non-resident net purchases of rand-denominated government bonds continued to rise sharply and are now at levels reminiscent of the large inflows of 2012 (at that point, sparked by an earlier global rush for yield as well as the inclusion of South Africa into the Citi Group Global Bond Index). While foreign capital inflows are welcomed, especially by countries like South Africa with current account deficits, the fact is that the unconventional and by now largely ineffective global monetary policy measures have caused unprecedented distortions in the majority of developed bond markets.

While we get the reasons for the rush into emerging market debt, it concerns us that foreign holdings of local currency RSA government debt is estimated to have reached a level close to 40% of total outstanding national government local currency debt. This equates to about R0.6 trillion. If history has taught us anything, it is that foreign portfolio flows tend to be fickle and that an orderly exit is never guaranteed. So, to us, this is posing an already high risk to future bond and currency market stability. Timing an exit has never been easy, if not downright impossible.

INFLATION EASES, GROWTH OUTLOOK WEAKENS

In terms of local economic developments, both consumer and producer inflation showed a moderation in the rate of increase during the last quarter. The August 2016 consumer inflation data release printed lower than expected at a year-on-year rate of increase of 5.9%. Although inflation at the producer level for the same month was significantly higher at 7.2%, the rate of increase had also slowed. On the negative side, the August external trade balance swung back into a significantly large deficit of R9 billion, following several consecutive months of large surpluses. Incoming activity data for the third quarter points to weaker GDP growth, following the better second-quarter data. Considering the above, it comes as no surprise that the South African Reserve Bank opted to adopt a neutral stance at the last monetary policy meeting.

Worryingly, tax revenue collections have disappointed during the first few months of the current fiscal year, potentially putting at risk the Ministry of Finance’s plans to reduce the fiscal deficit. We are also still concerned about the pressure some state-owned enterprises are placing on the fiscal position, even though this is taking the form of state guarantees.

Against this backdrop, the yield of the benchmark R186 (maturity 2026) gyrated between a best level of 8.34% and
weakest of 9.27%, before closing the quarter at 8.67% or thirteen basis points below the second-quarter close. The widely shared view of an improved longer-term inflation outlook continued to hamper the demand for inflation-linked bonds. As a result, real yields gradually grinded higher. For the quarter, the JSE All Bond Index returned a strong 3.4%, significantly better than both the official inflation-linked index’s return of 0.4% and cash’s 1.9%. On a year-to-date basis to the end of September, nominal bonds are still leading the trio with a total return of 15.1%, followed by inflation-linked bonds at 7.2%, while cash returned 5.4%.

**MONETARY POLICY’S DIMINISHING EFFECT**

The global growth recovery remains fragile and patchy, which sets the scene for a modest future inflation profile as well as significant monetary policy divergence. It also implies a steady and shallow tightening cycle for the few economies that are in a position to normalise monetary policy, especially the US. This should cap global bond yields. On the negative side, the continued uncertainty about the global, and particularly the Chinese, growth outlook remains a risk – especially for emerging market commodity producers with a weak external position in both absolute and relative terms, like South Africa. We also expect global risk appetite to remain volatile and do not regard market rallies boosted by expectations of more policy easing to be sustainable. If anything, we are starting to fear that the unintended consequences of unprecedented monetary policy measures among the major developed market central banks should not be ignored. Monetary policy has lost its effectiveness on final demand and instead has caused major distortions, mainly across developed bond markets. This requires a serious consideration of a change in the policy mix. The impact of fiscal spending on final demand tends to be more effective.

**CURRENCY SWINGS REMAIN A RISK**

Locally, we still expect a bout of upward pressure on inflation over the next three to four months, but are more focused on the downward trend expected for next year. While the South African Reserve Bank has now adopted a neutral bias, it is unlikely that it would consider interest rate cuts soon. The external imbalance is simply too big to allow for a lower real repo rate, while unpredictable currency swings continue to pose a risk to the more benign inflation outlook. Although the Minister of Finance is clearly determined to rectify the damage to fiscal policy credibility and, by implication, to avoid a sovereign credit downgrade to non-investment grade status, the jury is still out on actual delivery. Therefore, the risk of a sovereign credit downgrade over the next 12 months still hovers. In the short term, local political uncertainty remains a nagging risk. This is particularly worrying considering how much risk has been priced out of the market since the end of last year, mostly the result of the global reach for yield, which managed to whitewash the economic and policy sins of South Africa.

Considering the above, we will continue to approach the market with caution. The emphasis therefore remains on capital preservation. This is expressed by the large underweight modified duration and 12+ year nominal bond positions. We have significantly reduced our inflation-linked bond holding in response to the more benign 12-month inflation outlook and instead opted to create an overweight position in short- and medium-dated nominal bonds. The biggest risk to our cautious stance is sustained net foreign inflows into the local nominal bond market.

**ALL BOND INDEX (ALBI) TOTAL RETURN TO END SEPTEMBER 2016**

The bull rally in local bond yields and a stronger rand worked in favour of foreign investors over the past nine to 12 months. However, an unhedged currency position would have detracted significantly from local currency returns over a longer time horizon.

Sources for figures: i-Net, Futuregrowth (30 September 2016)
TOMORROW
AS INVESTED AS YOU ARE

KEY TAKEOUTS:
• ANNUAL RI EVENT FOCUSES ON BUILDING A PROSPEROUS TOMORROW
• BETTER-INFORMED DECISIONS INCLUDE ASSESSING ESG FACTORS
• THE FUTURE FAVOURS SUSTAINABLE INVESTMENT STRATEGIES
As responsible custodians of our customers’ wealth, we believe that systematically considering environmental, social and governance (ESG) factors in our investment process will likely lead to more complete investment analyses and better-informed investment decisions. To raise awareness of the importance of responsible investing, we hosted our first responsible investment conference last year.

The event has now become our premier annual event showcasing our responsible investment commitment and initiatives. Last month we held our second instalment of this responsible investment conference. Titled “A Ripple Effect. Our Tomorrow”, this year’s event brought together Old Mutual executives, investment professionals and clients to build on the conversations initiated in 2015. Dialogue offered a thorough interrogation and practical solutions regarding some of the most pressing issues surrounding sustainability and responsible investing.

We also launched the second edition of the Tomorrow, As Invested As You Are thought leadership publication at the events held in both Johannesburg and Cape Town. The book comprises insightful essays by investment professionals from Old Mutual Investment Group as well as external contributors from various fields.

REAL PROBLEMS NEED REAL SOLUTIONS

Opening the conference on a decidedly different and unique note, author and poet Mbali Vilakazi recited her poem titled: “Is there a Xhosa word for climate change?” She gave a voice to the everyday people impacted by the world’s changes and others’ responsible investment actions, or lack thereof.

Topics discussed at the conference included the key role of sustainable organisations, the importance of corporate governance in an ever-dynamic emerging markets universe, as well as how it is possible, and important, to invest both responsibly and profitably. The resounding message throughout all the talks was that when it comes to investment returns and making a positive impact, it is a case of “and”, not “either/or”. Responsible investment offers practical solutions that allow investors to do well and do good.
There is often a misperception from investors (as well as asset managers and advisers) that responsible investment practices detract from investment performance.

The claim is that the consideration of environmental, social and governance (ESG) factors in the investment process, coupled with active stewardship of assets, is costly, potentially constraining and detracts from performance.

However, the emerging academic and industry evidence, supported by our own analysis, paints a very different picture.

So how can investing responsibly give investment managers and their clients an edge? And what are the keys to getting it right?

**WHAT DO WE VALUE?**

Responsible investment is often confused with the simple process of excluding stocks based on ethical criteria. The reality is that responsible investment is a far more nuanced approach that is primarily concerned with the long-term impact of ESG-related risks and opportunities on a company’s cash flows and valuations.

Perhaps one of the more striking points to consider is that in the modern era most company values are derived from intangible
assets – such as goodwill, intellectual property rights, product safety, reputation, innovation, management quality, staff loyalty, social licence to operate etc. – rather than tangible assets such as plant and equipment. Recent estimates indicate that the market value of the US S&P 500 Index arising from intangible assets sits at 84%, up from less than 20% in 1974. Given that many ESG issues directly influence a company’s intangible value, it makes sense to understand how exposed a company is to ESG issues, and how capable the leadership team is of managing these risks and opportunities.

In essence, sustainability is a trend shaping the competitiveness of firms across all sectors, and companies that can respond early relative to their peers will show lower cost of capital, better resource efficiency, stronger innovation, better social licence to operate, stronger staff retention and, ultimately, stronger competitive advantage. The most compelling research in this regard is from Harvard Business School over a 20-year period – their findings show that companies with strong sustainability performance showed both market and accounting based outperformance against their peers with weak sustainability performance.

**BUILDING OUT THE EVIDENCE**

Over 300 academic and industry studies have now been published analysing the impact of ESG strategies on investment performance. We have assessed many of these studies and the evidence to date suggests that, through full market cycles and across markets, the consideration of ESG issues in investment strategies does not negatively impact returns. Indeed, what is interesting is that many of the more recent studies indicate that, if correctly applied, ESG integration can be additive to investment performance.

Much of the analysis undertaken to date has been on global markets, with very little available in the South African context. To remedy this, Old Mutual’s Responsible Investment team tested the MSCI ESG data set for the South African market over the past four years using an approach consistent with similar international studies. While the data set only extends over four years, the results look promising, with highly rated ESG firms performing better than poorly rated ESG firms over the period assessed. These findings are consistent with work undertaken by MSCI on both the global and emerging market data sets over a nine-year period. We still have much work to do in this regard but we believe the best way to get ahead is to get started.

**COMPONENTS OF INTANGIBLE VALUE**

<table>
<thead>
<tr>
<th>COMPONENTS OF US S&amp;P 500 MARKET VALUE</th>
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<tbody>
<tr>
<td>Tangible Assets</td>
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<td>17%</td>
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<table>
<thead>
<tr>
<th>COMPONENTS OF INTANGIBLE VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Brand value (price premium, brand awareness)</td>
</tr>
<tr>
<td>2. Reputation (social media profile, opinion research)</td>
</tr>
<tr>
<td>3. R&amp;D pipeline (# patents)</td>
</tr>
<tr>
<td>4. Customer satisfaction (retention, loyalty, boycotts)</td>
</tr>
<tr>
<td>5. Health &amp; safety (product recall, incidents, accidents, near misses)</td>
</tr>
<tr>
<td>6. Environmental performance (pollution, penalties, fines, enviro capex)</td>
</tr>
<tr>
<td>7. Social licence to operate (production delays, costs overruns, labour protests)</td>
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<tr>
<td>8. Governance (board composition, bribery, pay, ethics)</td>
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</table>

At present, our Customised Solutions investment boutique is already leveraging these insights into our newly launched South African Responsible Equity Index. This work builds on the analysis we undertook in 2015 that supported the launch of the Old Mutual MSCI World and Emerging Market ESG Index Funds. Building on this, Old Mutual Equities – our fundamental equity capability – already integrates ESG analysis into its fundamental company analysis and is now exploring the best method to leverage this information in the context of its factor model.

CONVERGING FORCES

We see three powerful forces converging that make responsible investing not only a necessary response to the changing nature of global risk and opportunity, but also an important evolution in the role and function of the asset management industry:

1. The myriad of interconnected ESG issues present a material impact to stable, long-term economic growth at a local, national and global level³. Governments alone will not solve these issues and all sectors, including the financial sector, can and must play a role in addressing these issues. Coupled with this, expectations are changing across society as company stakeholders – employees, customers, shareholders, regulators, civil society etc. – increase their demands in respect of company ESG performance. In our connected world, how a company responds to these issues will influence its market competitiveness. The good news is that the evidence shows that profitably and low carbon, socially inclusive and resource-efficient growth can co-exist.

2. The asset management industry faces an existential crisis as critics question its societal value and push back against fees, while on the flip side there is a growing investor base seeking to align their portfolios with their personal values and make the world a better place⁴. Responsible investment has the potential to serve as a powerful catalyst for realigning the asset management industry with societal concerns while at the same time meeting investor expectations.

3. Lastly, there is a growing understanding that continued short-termism is problematic at a systemic level. Primarily, short-termism undermines future economic growth due to the lack of long-term capital investment, which ultimately leads to slowing GDP, higher unemployment levels and lower future investment returns for savers⁵ — implications that could hurt everyone. Global asset owners are now turning to responsible investment as a means of driving long-term value creation.

A deep understanding of these secular trends, along with hands-on, tangible evidence of the positive value that can be derived from an analysis of material ESG issues, supports our view that responsible investment can and does add value to long-term client outcomes.

¹ http://www.hbs.edu/faculty/Publication%20Files/12-035.pdf
² Can ESG Add Alpha? - MSCI June 2015
³ WEF annual risk assessment survey
⁴ TIAA Global Asset Management survey of investors and advisers 2016 - Over three-quarters (77 percent) of the affluent US investors say that they want their assets to have a positive impact on society
⁵ Focusing Capital on the Long Term, 2015 Report
KEY TAKEOUTS:

- SA’S OLDEST UNIT TRUST TURNS R338* INTO R1 MILLION
- CONSISTENCY REQUIRES DISCIPLINE AND PATIENCE
- RETURNS ARE DRIVEN BY BOTH CHOOSING WINNERS AND AVOIDING LOSERS
A DISCIPLINED APPROACH DELIVERS CONSISTENT RETURNS

PETER LINLEY | HEAD OF OLD MUTUAL EQUITIES

In early October, Old Mutual Investors’ Fund turned 50. As South Africa’s longest running unit trust, the fund has delivered 17.4% a year (that’s 8.4% a year above inflation). To translate this into a rand value, a one-off investment of R338.04* made on 1 October 1966 would be worth around R1 million (as at 30 September 2016) – growth achieved during a time of extreme political turmoil and a number of global market crises.

Over the past decade, the Fund’s performance is a testament to the successful track record of the Old Mutual Equities investment team. So what has made this consistent performance track record possible?

DISCIPLINE, PATIENCE AND DIVERSIFICATION

An asset manager is only likely to deliver consistently if it has the following: a sound investment process that includes disciplined valuation, patience, stringent risk management, intelligent diversification and a critical evaluation of past decisions.

Being successful in today’s ultra-competitive asset management environment is not so much about being a star manager over a one-year period. Anyone can be lucky in the short term. The real test of a successful manager is one who performs over time. Gone are the days when having a couple of big teams covering the market may have given you an edge. These days, what separates the good from the average manager is using sound principles that focus on the process, rather than the outcome.

VALUATION – SCIENCE AND ART

The bedrock of a sound investment process is disciplined valuation, but it is also important to acknowledge other proven factors, such as quality, growth and sentiment. Valuation is key, but it is subjective. While we continually revisit and test our base-case assumptions, we also seek to gain further perspective by constructing bull- (rising market) and bear- (falling market) case scenarios for each company. Banks, for example, are not

FTSE/JSE ALL SHARE INDEX IN PERSPECTIVE 1966 - 2016

Source: i-Net, September 2016

* Troubled Asset Relief Program (TARP)
only trading at an attractive discount to our base-case valuation, but are actually trading around our bear-case scenario. The shares are effectively pricing in a sovereign downgrade already.

There is a good behavioural reason for encouraging our analysts to focus on three scenarios. Rather than stressing about one single base case, we gain more value and insight from the analyst’s probability weighting in addition to the three scenarios. A single focus encourages the negative behavioural aspect of “anchoring” that we want to avoid.

Understanding valuation is our main focus, and for good reason. Value as a style outperforms over the long term, but it can go through lengthy periods of underperformance. Our research into the performance of other factors in the South African market over the last 26 years shows that value is not the only outperforming factor. By adding other long-term outperforming factors to our valuation ranking improves diversification and provides a more holistic insight when picking stocks. Managers often underestimate the subjectivity in their valuations and, at times, could be making massive macro assumptions that are highly risky. The feedback we get from the non-value factors provides ongoing challenges and further insight to our subjective assumptions.

It is also critical to constantly analyse the failure and success of decisions. It’s important to know if we were right for the right reasons, or right for the wrong reasons and so just lucky. Investing is as much about psychology and human emotions as is it about science and maths.

No individual can forecast the future with much accuracy, which is why we embrace a probability perspective, rather than believing there is just one view and that our version is the correct one. We want to understand the different outcomes that may play out over time and assign a probability to these.

**PATIENCE PAYS**

There also needs to be a long-term perspective on the company and its share price, rather than worrying about what it will return in a month’s time. Markets across the world are largely driven by short-term behaviour, and emotionally driven decisions destroy returns. To succeed, a successful investment management team needs a sensible investment philosophy and must operate within a disciplined and structured process.

**SOUND RISK MANAGEMENT**

Throughout the investment process, a priority on risk management is essential. We are paid to take on risk on behalf of the investor, so teams need to continually guard against unintended risk. Outperformance is not only driven by the winners in our portfolios, but also by avoiding the losers, such as African Bank. That is all part of the risk management process. The risk of capital loss in African Bank was simply too big for us. The nature of what we do means we will be wrong at times and sometimes the best option is to cut our losses and move on to other, better opportunities. The worst thing you can do as an investor is hang on to poor performing stocks that in reality have no ability to recover.

**INTELLIGENT DIVERSIFICATION**

Once you have done all the share-specific research, intelligent diversification is essential. It’s not how many shares you buy, but the diversity of these stocks. Even 20 stocks may not be intelligent diversification if they are all in the same industry or fit in the same style bucket. Ensuring adequate diversification requires an analysis across shares, industry, style, macro drivers, regions, currencies and more.

Achieving geographical diversification in South African portfolios is a lot easier than it was 50 years ago. Companies listed on the JSE, including Naspers, British American Tobacco, Richemont, AB InBev, Mediclinic, Steinhoff, Mondi and Aspen have a strong presence outside of South Africa.

There are no short cuts to delivering competitive returns over the long term. A sensible philosophy, combined with a disciplined process, is part of the fabric of Old Mutual Investors’ Fund. But as a team we consider the constant evaluation of past decisions critical, and that separates us from many other managers.

As information flows quicker than ever before, it is increasingly difficult to successfully manage an equity portfolio without this combination of attributes.

# Old Mutual Unit Trust Managers (RF) (Pty) Ltd (ONUT) is a registered manager in terms of the Collective Investment Schemes Control Act 45 of 2002. The fund fees and costs that we charge for managing your investment are accessible in the relevant fund’s Minimum Disclosure Document (MDD) or Table of fees and charges, both available on our public website, or from our contact centre. The Net Asset Value (NAV) to Net Asset Value figures are used for the performance calculations. The performance quoted is for a lump sum investment and in respect of the Old Mutual Investors’ Fund. The performance includes income distributions prior to the deduction of taxes and distributions are reinvested on the ex-dividend date. Actual performance may differ as a result of actual initial fees, the actual investment date, the date of reinvestment and dividend-withholding tax. Past performance is not a guide to future performance. Annualised returns are the weighted average compound growth rate over the performance period measured. The actual highest, average and lowest 12-month return figures since inception to 30 September 2016 are 96.0% (highest), 20.0% (average) and 45.7% (lowest). The fund was launched on 31 October 1966. Morningstar and Old Mutual Investment Group calculated the performance of the fund as at 31 August 2016. Old Mutual is a member of the Association for Savings & Investment South Africa (ASISA).
KEY TAKEOUTS:
- Market cycles put single-factor approach at risk
- Smart beta can increase tracking errors
- Diversify factors based on active research
As interest in passive investing has grown in South Africa, so has the attention on “smart beta” funds. Passive funds appeal to investors for their transparency, low costs and performance targets in line with an index. Many investors drawn by these characteristics, but wanting returns in excess of the index, are turning to “smart beta” strategies.

Smart beta simply refers to an investment strategy that has a constant tilt or exposure to predetermined factors. These factors include strategies like value, momentum, quality, yield or low risk – each of which typically explains historical risk within an investment portfolio. The idea behind smart beta stems from the Arbitrage Pricing Theory, which essentially says that returns are related to risk factors and that the market return isn’t necessarily the optimal blend of factors – so being exposed to one or more factors is better, over the long term, than accepting the inherent factor composition of the market. A smart beta strategy aims to isolate these factors relative to the market in a transparent and rules-based process.

While these factors all hold merit in an investment strategy, what many investors ignore is that markets move in cycles and that different factors perform under different conditions. How these factors are implemented within a fund also vary widely, so no one smart beta strategy is like another. For these reasons, investors need to be mindful of the following considerations:

As mentioned, smart beta portfolios are restricted to the selected factor/s, and ignore potential returns from other factors not captured in the fund. The chart shows just how the returns of the different factors vary over time. In addition, while the cyclical or return variability of the selected factors can lead to outperformance, periods of underperformance can be protracted as the fund adheres to the factor rules regardless of market conditions.

To protect against the potential of a factor underperforming, investors may decide to invest in a range of smart beta funds that target different factors. However, treating factors as separate strategies opens the door for implementation.

**SOME WIDELY USED RISK FACTORS**

<table>
<thead>
<tr>
<th>Factor</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>MOMENTUM</td>
<td>Companies with share prices that have kept rising.</td>
</tr>
<tr>
<td>VALUE</td>
<td>Shares that are cheap relative to the company’s longer-term value.</td>
</tr>
<tr>
<td>EARNINGS QUALITY</td>
<td>Profitable companies with stable earnings and low debt levels.</td>
</tr>
<tr>
<td>EARNINGS YIELD</td>
<td>Companies with higher-than-average dividend yields.</td>
</tr>
<tr>
<td>VOLATILITY SENSITIVITY</td>
<td>Shares delivering excess returns, but with lower volatility than the index.</td>
</tr>
</tbody>
</table>
inefficiencies and higher costs at an overall portfolio level. Transaction costs increase when, for example, one fund buys “cheap, out of favour” shares for its value smart beta strategy, while at the same time the other fund is selling those exact shares to rebalance its momentum strategy.

Conversely, there’s a risk that investors all favour the same strategy. This may leave the approach prone to “factor overvaluation” – where too many investors are trading shares on the basis of the generic factor definitions.

**VARYING RETURNS OF DIFFERENT FACTORS**
**FEBRUARY 2000 - AUGUST 2016**

Smart beta strategies can also result in investors taking on additional risk, as these strategies tend to have high tracking errors relative to conventional market capitalisation weighted benchmarks. This happens when portfolios become biased towards a sector or an individual company driven by the rules of the selected factor.

There are many different ways of creating a smart beta strategy. The “purity” of exposures to factors can vary depending on how this is implemented by the investment manager, which may be long-only, long-short or optimised. In addition, smart beta funds in South Africa have a relatively short track record, making it difficult for investors to understand how these different strategies perform under different market conditions.

Critically, smart beta strategies shift the decision and risk regarding the selection of factors and the timing of factors from the investment manager to the investor. Few investors have the information needed to effectively allocate money across factors. Similar to asset allocation or stock-picking decisions, factor allocation decisions are best left to investment managers with a demonstrable skill in this area.

**A BETTER WAY TO GET FACTOR EXPOSURE**

In light of these concerns, is it possible to get factor exposure via a smart beta strategy without the pitfalls? In our opinion, the multi-factor approach, used for our Managed Alpha strategies, offers the benefits of smart beta strategies without the pitfalls. It is what we call “smarter beta”, with the following characteristics:

1. The strategies simultaneously target a range of diversified factors or risk premia. These factors are enhanced over time based upon our proprietary research. Multi-factor diversification also leads to less cyclical returns and more consistent outperformance.

2. The weights assigned to the various factors in the strategy are time varying – reflecting the changing nature of the risk/reward relationship for all the factors and the degree of factor over- or undervaluation.

3. The inter-relationships/covariance of the various factors is systematically taken into account in constructing the portfolio.

4. Tracking errors are managed by the investment manager for a given level of client-mandated tracking error, ranging from low to high.

5. Implementation efficiency or transaction costs are likely to be lower than diversifying across multiple smart beta portfolios, as the various factors are not considered as separate portfolios, but rather as a single multi-dimensional portfolio. A share will never be simultaneously bought and sold. Transaction costs are also explicitly managed.
6. Factor definitions are proprietary and are therefore less prone to the factor overvaluation that is prevalent in a generic factor definition.

7. Investment managers take the risk and the responsibility for the selection of factors and the timing of the various factor exposures.

**TIME TELLS ALL**

We have been managing the Old Mutual Managed Alpha Fund since January 2000. According to Morningstar, as at 30 September 2016 the Old Mutual Managed Alpha Equity Fund has delivered top quartile performance over all periods from two to eleven years.

The Old Mutual Managed Alpha Equity Fund achieves its performance from diversified exposures to multiple factors/risk premia without having to assume any of the pitfalls of smart beta investing. Dynamically managing exposure to factors in light of changing risk/reward relationships, while managing tracking error, is where long-term outperformance is generated.

**OLD MUTUAL MANAGED ALPHA EQUITY FUND TAKES THE BEST OF SMART BETA**

**TRACKING ERROR VS ALPHA/OUTPERFORMANCE JANUARY 2000 – SEPTEMBER 2016**

Source: Old Mutual Investment Group, 30 September 2016 2016

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## MARKET INDICATORS

**AS AT 30 SEPTEMBER 2016**

<table>
<thead>
<tr>
<th>Economic Indicators</th>
<th>Latest Data</th>
<th>Previous Year</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Exchange Rates</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rand/US$</td>
<td>September-16</td>
<td>13.7</td>
</tr>
<tr>
<td>Rand/Pound</td>
<td>September-16</td>
<td>17.6</td>
</tr>
<tr>
<td>Rand/Euro</td>
<td>September-16</td>
<td>15.4</td>
</tr>
<tr>
<td>Rand/Aus$</td>
<td>September-16</td>
<td>10.5</td>
</tr>
<tr>
<td><strong>Commodity Prices</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gold Price (US$)</td>
<td>September-16</td>
<td>1312.0</td>
</tr>
<tr>
<td>Gold Price (R)</td>
<td>September-16</td>
<td>18348.2</td>
</tr>
<tr>
<td>Oil Price (US$)</td>
<td>September-16</td>
<td>50.0</td>
</tr>
<tr>
<td><strong>Interest Rates</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prime Overdraft</td>
<td>September-16</td>
<td>10.5%</td>
</tr>
<tr>
<td>3-Month NCD Rate</td>
<td>September-16</td>
<td>7.4%</td>
</tr>
<tr>
<td>R1 180 Long-bond Yield</td>
<td>September-16</td>
<td>8.7%</td>
</tr>
<tr>
<td><strong>Inflation</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CPI (y-o-y)</td>
<td>August-16</td>
<td>5.9%</td>
</tr>
<tr>
<td><strong>Real Economy</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP Growth (y-o-y)</td>
<td>June-16</td>
<td>0.6%</td>
</tr>
<tr>
<td>HCE Growth (y-o-y)</td>
<td>June-16</td>
<td>1.0%</td>
</tr>
<tr>
<td>GFCF Growth (y-o-y)</td>
<td>June-16</td>
<td>-3.3%</td>
</tr>
<tr>
<td>Manufacturing Production (y-o-y) (seasonally adjusted)</td>
<td>July-16</td>
<td>2.5%</td>
</tr>
<tr>
<td><strong>Balance of Payments</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trade Balance (cumulative 12-month)</td>
<td>August-16</td>
<td>-$0.4</td>
</tr>
<tr>
<td>Current Account (% of GDP)</td>
<td>June-16</td>
<td>-3.1%</td>
</tr>
<tr>
<td>Forex Reserves (incl. gold)</td>
<td>August-16</td>
<td>$45.9</td>
</tr>
</tbody>
</table>

Sources: JSE, Iris, INI

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We have a clear understanding of our clients because we are, in effect, clients ourselves.

Peter Linley
Boutique Head
Old Mutual Equities

INVEST WHERE THE FUND MANAGERS INVEST

At Old Mutual Investment Group, our fund managers invest their own money alongside yours.

This year, Old Mutual Investors’ Fund, South Africa’s longest running unit trust, celebrates its 50th birthday and has delivered top quartile performance over 1, 2, 3, 4, 5, 6, 7 and 10 years.

Speak to an Old Mutual financial adviser or your broker about investing alongside our fund managers or call 0860 INVEST (468378).

www.oldmutualinvest.com/asinvested