Robert Cowen Investments

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Newsletter

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The Family Office

You are welcome to pass this newsletter on to friends who may wish to learn more about investment.
To be added to our email, contact alan@rcinv.co.za

"Don't judge each day by the harvest you reap but by the seeds you plant."
~ Robert Louis Stevenson

"I can't change the direction of the wind, but I can adjust my sails to always reach my destination."
~ Jimmy Dean

RCI MET Flexible Fund – closed December at 368.12, up 0.64% for the month. It is 8.30% lower than 12 months ago. The JSE Top 40 was down 1.37% for the month and is down 5.91% versus a year ago. However, as we are not investing much in mining shares (because of the risks) it is more useful to compare us with the FINDI 30 Index which was down 8.27% for the period. So performed exactly in line with the non-mining Index. Our preponderance of rand hedges when the rand actually rose during the year did not help but you are well aware of why we are sceptical about the rand over three years despite the short- term strength resulting from the strong metal prices of the past quarter.

We wish you all a very happy New Year. May your investments go from strength to strength! May South Africa prosper!

Visit our website: www.rcinv.co.za for back copies of the newsletter, background information, etc.

Quotes from Stephen Wright.

Words of wisdom from Michel Pireu.

Today one in 8 people are over 60, by 2050 this will increase to one in six!

How we see 2017 panning out.

Annexure A: Last year's predictions for 2016 – what we got right and wrong. Mainly we did not expect mining to do so well but it remains to be seen if this was a short term blip or a sustainable change in long-term trend.

The quotes of Steven Wright (some of these are excellent)

1. I'd kill for a Nobel Peace Prize.
2. Borrow money from pessimists -- they don't expect it back.
3. Half the people you know are below average.
4. 99% of lawyers give the rest a bad name.
5. 82.7% of all statistics are made up on the spot.
6. A conscience is what hurts when all your other parts feel so good.
7. A clear conscience is usually the sign of a bad memory.
8. If you want the rainbow, you got to put up with the rain.
9. All those who believe in psycho kinesis, raise my hand.
10. The early bird may get the worm, but the second mouse gets the cheese.
11. I almost had a psychic girlfriend, ... But she left me before we met.
12. OK, so what's the speed of dark?
13. How do you tell when you're out of invisible ink?
14. If everything seems to be going well, you have obviously overlooked something.
15. Depression is merely anger without enthusiasm.
16. When everything is coming your way, you're in the wrong lane.
17. Ambition is a poor excuse for not having enough sense to be lazy.
18. Hard work pays off in the future; laziness pays off now.
19. I intend to live forever ... So far, so good.
20. If Barbie is so popular, why do you have to buy her friends?
21. Eagles may soar, but weasels don't get sucked into jet engines.
22. What happens if you get scared half to death twice?
23. My mechanic told me, "I couldn't repair your brakes, so I made your horn louder."
24. Why do psychics have to ask you for your name?
25. If at first you don't succeed, destroy all evidence that you tried.
26. A conclusion is the place where you got tired of thinking.
27. Experience is something you don't get until just after you need it.
28. The hardness of the butter is proportional to the softness of the bread.
29. To steal ideas from one person is plagiarism; to steal from many is research.
30. The problem with the gene pool is that there is no lifeguard.
31. The sooner you fall behind, the more time you'll have to catch up.
32. The colder the x-ray table, the more of your body is required to be on it.
33. Everyone has a photographic memory; some just don't have film.
34. If at first you don't succeed, skydiving is not for you.
35. If your car could travel at the speed of light, would your headlights work?

A few words of investment wisdom

Extracts from an article by Michel Pireu -Business Day 10 January 2017

"Nobody can come close to predicting the future -it's a lesson I need to keep relearning every year … month … week … day." – Bob Seawright

"There is nothing harder for most investors than thinking beyond the short term, even when they know that is exactly the problem." – Brian Portnoy. The day -to-day events that dominate investment news are like waves crashing on the beach: unique, absorbing … and ultimately inconsequential.

The notion that anyone, even the most seasoned pros, can consistently outsmart the markets is fantasy.

How the world is aging - important long term trend

"Today, one in eight people worldwide is aged 60 or over. By 2030, it will be 1 in 6, and by 2050, 1 in 5." Jerry Thomas of Sarasin newsletter January 2017.

Forecast for 2017

The point of an annual forecast is not be right (but of course, that is preferable) but to lay a groundwork for an investment strategy.

We never forget that the vast majority of our clients have retired so cannot easily make back money that has been permanently lost.

We seek to buy shares in solid, growing companies that have limited risk of permanent losses. For example, Naspers, one of our favourite shares was down by 5% during 2016. Partly, this was due to changes in the way Indices are being constituted and due to the strength of the rand. We believe that Naspers will go to over 3000 (from 2000) over the next three years. Thus it cannot be sold in the short term, which would trigger a huge capital gain and result is us not having the cash to buy all the shares back. If we felt that the story had turned negative and the value would be less than 1500 in three years' time, we would sell but we do not, so the wisest course of action, based on the balance of probabilities, is to hold it and wait for better times. Already in 2017, it has turned up by 7%!

Naspers – slight drop for 2016 but unlikely any threat of long-term loss – already turning up in 2017

Most of the performance in 2016 was in risky mining shares, and was in the first two months of the year.

Over the past year, for the first time since 2012, the resources (mining shares) outperformed. For the previous five years they underperformed. During 2016, they bounced and the fundamental question is "Have metal prices bottomed?" or will the metal cycles of the past century roughly repeat themselves, in which case we have over ten years of pressure on prices. Either way, it makes betting on metals a very precarious thing to do at this point. There has been a huge build-up of supply of metals, just at a time when China is at risk of slowing down its demand for metals. As detailed below, China uses more than 50% of most metals so this is the most vital question to be answered.

The JSE Resources 20 Index (bottom chart) and performance relative to the JSE Overall Index

From 2008, Resources have been a bad place to be and the index level fell from over 7000 to under 3000. In 2016, the Resources 20 jumped 25% so if you were not in mining shares you underperformed. So why were we NOT in mining shares? Firstly, 23% gain in the first 2.5 months caught us flat footed, then we waited for a pullback which never came. Secondly, and most importantly, the relative performance (despite its improvement in 2016) has still not broken its downtrend line (the solid red line in the top graph), although it is now close. Only when this downtrend has clearly broken can it be said that the tide seems to have turned and mining shares can then be purchased with conviction. We are long-term, low risk investors so it is prudent to wait for this downtrend to be broken, particularly when history shows that it normally takes 20 years for the next mining up cycle to begin. Mining earnings peaked in 2012 so we could have a long way to wait!

We had also feared that the rand would get weaker in 2016, particularly if a downgrade of South Africa by the rating agencies took place. The downgrade was avoided (partly due to strong metal prices, and the sterling efforts by Finance Minister Gordhan) and the rand strengthened. Thus our heavy investment in rand hedges failed to pay off.

However, investing our clients' money is not a short term business. The balance of probabilities is that the rand will weaken over the next five years. Thus we will remain heavily invested in rand hedges. All it takes is for metal prices to fall or Mr. Gordhan to get ill (we are under the impression that ill-health was why he left his first spell as Finance Minister) for the rand to come under intense pressure. We would rather be safe in the long-term even if it might mean short term underperformance. This approach led to substantial, low risk out-performance from 2010 to 2015, so we see little reason to change our approach until the FACTS change.

We want companies with a high return on capital and good free-cash flow.

This has proven to be the safest way to invest in times of uncertainty, and uncertainty prevailed in 2016. In any event, we could not sell your entire portfolio and reinvest it into mining shares without incurring a huge capital gain tax on your behalf.

We view the most important thing for your portfolio is that it keeps on growing (or at least maintaining) the dividend income during tough times. Many of our top financial and industrial shares have shown wonderful dividend growth over the past ten years in spite of the world financial crisis whereas many mines had to severely cut their dividends.

So first we look at the scenarios for the world.

The USA, Europe and Asia are the key players.

Then we look at the ramifications for South Africa.

Then we choose safe, quality shares that should continue to show growth in dividends.

We like shares that should do well over five years – a one-year underperformance is largely irrelevant – what will show great growth over the next five years, without much risk?, is the question that occupies our minds. If the company pays a good solid dividend at least you have something to live on while waiting for share prices to recover.

So in the year ahead, we seek a balance of risk and reward. The most important issue is to NOT LOSE permanent capital. We would rather have plenty invested in the US market yet see the rand strengthen, than have little invested offshore and see the rand weaken!

So let us examine the detail.

Market Outlook 2017 by Eric Lappeman and Andrew Lawson

The U.K. broke away from the European Union, the Americans elected Donald Trump as president. Despite all the doom and gloom, the world economy managed to cling on. So, considering all the surprises that happened last year, is it really worth predicting what may or may not happen in 2017? Probably not. "The only certainty in life is uncertainty'. Hence we should at least expect more surprises. With that in mind, let us lay out some of our thoughts on where 2017 may take us…

South Africa- a slightly easier year than 2016 but much depends on the metal prices staying high – and a downgrade being avoided.

We did not expect much for South African companies at the start of the 2016 year. 2016 was torrid for most industrial companies but we are beginning to see a 'sliver' of a silver lining on the horizon. The International Monetary Fund has upgraded SA's growth outlook to 1.2% for 2017. This is dependent on a number of factors:

The Drought is over

Last year we witnessed a severe drought that led to food shortages across the country and sharp increases in food inflation (due to shortages but also due to the cost of importing maize to meet the demand). The negative impact of the drought on growth last year has probably been underestimated and that the low base effect set should allow for improvement in 2017. The higher rainfall during the last quarter of 2016 and into 2017 points to a drop in food prices. This should alleviate some of the pressure on consumers and upon inflation and lead to more disposable consumer income. The question is, how much of this benefit will be offset by the rally in the oil price to well above $50 a barrel?

Stabilising commodity prices

In 2016, commodities scored their strongest yearly gains since 2010. It was a good year for commodity exporting countries such as South Africa from this point of view. Most commodities were previously trading well below their marginal cost of production, for an extended period of time. This, coupled with large amounts of oversupply, led to producers worldwide having to reduce output and cut investment in future projects. This supply response is slowly rebalancing the market and hence commodity prices have rallied to what some believe to be sustainable levels. If prices hold at current levels then our miners stand to benefit handsomely, in turn equating to more revenue for SA. Rand weakness would help this further and the fact that the Brazilian Real was up 60% in 2016 puts their mining costs under pressure relative to ours. Historically, a strong dollar has been bad news for commodity prices so the question still remains, how much of last year's demand was due to short term re-stocking in China and delivery problems in Australia versus how much is due to the promise of increased infrastructure spend in the US? Time will tell but the prospects seem brighter than a year ago.

The rand is always an issue.

An overriding factor for South African investors is the value of the rand. At the end of 2015, the rand had a large fall when the finance minister was fired. Off this weak base, it managed to strengthen due to efforts of the new finance minister, Mr Gordhan in staving off threatened downgrades for South Africa as well as the strong metal prices of the past few months and the difficulties that many other countries faced. It is cold comfort that compared to other countries, we are not too bad! We only expect a growth rate of about 1.5% (if the metal prices hold up and the rains continue) whereas our population is growing at a more rapid rate. We have over 30% of our people out of work – their lives will only get tougher!

Politics seen as unsettled.

We expect politics in SA to remain noisy, especially as the ANC's elective conference in December will dominate the year, but it does also seem that the market has largely become bored with attempting to follow the intricacies of the ANC's internal policies. It is unlikely that President Zuma will be replaced before the end of the elective conference in December. We should not rule out the possibility of a cabinet reshuffle, particularly as Minister Gordhan has a record of poor health so his replacement could have unfathomable consequences for our economy. In addition, we express concern over the possibility of the nuclear deal being concluded as this would stretch our credit worthiness.

Prior to 2016, our higher interest yield offering seemed adequate compensation to entice foreigner's to buy our gilts but with the prospect of higher interest rates in the USA and a stronger dollar in the U.S. will foreigners continue to sell our gilts as they did in 2016?

With inflation likely moving lower, growth starting to pick up and the fact that we are the 'least bad' of the EM bunch, we see 2017 as a better year than 2016 but we would caution of some very real factors that could tilt the outlook negative (credit downgrade, state of affairs at Eskom, possible ANC splits and a 'Gordhan exit'). So there is still about a 40% chance of a country downgrade but a year ago we would have predicted a 60% chance.

So what are the main external factors influencing South Africa?

USA – Mr Trump has changed the outlook – at least for now!

The U.S. is still, by far, the world's largest economy. It represents almost a quarter of everything that is produced in the world. If it grows, so too should most other economies.

While growth in the U.S. was previously muted due to many sectors being increasingly strangled by regulations, this no longer seems to be the case leading into 2017, courtesy of Mr. Trump. The promise of an important decrease in regulatory and tax burdens on U.S. businesses as well as sizeable infrastructure spend could suggest that the U.S. economy will grow faster than most had previously expected. The International Monetary Fund has increased its forecast of U.S. GDP growth to 2.2% for 2017 (Mr. Trump has vowed to reach 4%). If his administration can live up to his campaign promises, then the U.S. should be a more attractive place for doing business and a strong performance of shares should follow. One might of course say, "Talk is cheap but money buys the whiskey", but there has been an encouraging increase in both consumer and business confidence since the election.

In addition to the benefits that Trump seems to have brought to the U.S., we are now more certain that their fiscal and monetary policy will continue to tighten in 2017. In particular, there is now talk of three possible rate hikes on the cards for 2017. Unfortunately, this should lead to a stronger dollar (some predicting parity with the Euro around the corner) acting as a magnet for capital flows.

A strong dollar is not normally conducive for commodity prices to rise. A stronger dollar could also hamper growth in the U.S. by placing increasing pressure on U.S. corporate profits earned abroad. This happened in 2016 and we expect this trend to continue in 2017. Hence our preference is to be invested in U.S. centric companies.

In addition to this, a rule of thumb is that a 10% rise in the dollar should increase the trade deficit by 1% which, in turn, leads to the loss of hundreds of thousands of jobs. That said, one of the benefits of rising interest rates in the U.S. is the end of the long bull market in bonds which may cause increased flows into shares, out of bonds.

In summary, we believe that the U.S. is on a path to recovery (reinforced by positive signals coming out of job numbers, housing starts and inflation ticking up and lastly the FED finally hiked rates). The U.S. should show the strongest growth in the developed world and its currency should remain strong. Of course, Mr Trump might be unable to pass half the legislation he intends. In addition, possible trade-wars lead to increased barriers, higher cost of production and hence detract from global growth. However, these problem are unlikely to manifest in 2017. Taking all of these factors into account, we believe the balance of probabilities lies to the upside…

Europe -what is the chance of the breakup continuing?

The shock vote by Britons to leave the EU in 2016 – commonly referred to as 'Brexit' – has continued to send waves through the EU. In the days that followed the Brexit vote, the Pound lost some 10.6% against the dollar. By the end of the year, as further ramifications have been processed, the pound finished the year some 16.7% weaker against the dollar.

This has some far reaching effects on both the UK economy, and the EU in general. In November 2016 the European Commission cut their 2017 GDP forecasts for the 19 country Eurozone.

Underpinning this vote, and as witnessed on a global scale with events such as the US Trump election, is the rise of protectionism and populism. In the UK this could best be described as protecting their population against an increased number of migrants potentially taking jobs away from residents. The result for the UK at this juncture is higher expected inflation on the back of a weaker pound and therefore more expensive imports. This higher inflation would be expected to weaken the pound against the dollar, and euro, further.

This impacts shares listed on the London stock exchange as for companies with revenues earned mainly in the UK they will produce less dollar income, but companies with revenue based outside of the UK would see increased pound earnings as they convert dollar revenues at higher rates. Thus, companies with globally diversified revenue streams should see less of an impact on their share prices in dollar terms whereas UK based companies with UK based earnings would likely underperform against more globally diversified businesses.

A concerning impact of the Brexit vote, is the rise of political uncertainty that is spreading throughout the rest of the EU. This creates volatility in the political sphere, but also in the business environment on which companies rely to produce income and grow over time. In the coming year there are key elections in the Netherlands, France and Germany – three of the larger economies within the EU. Any unexpected election results, with the possibility of further countries indicating their intention of leaving the EU, as well as the rhetoric of politicians in the lead up to these elections, will no doubt cause added volatility in global markets. Is this the beginning of the end of the EU?

Our belief is that with the uncertainty currently prevailing in the EU and hence the possible devaluation of the euro against the dollar, the EU needs to be continually assessed for both investment risks as well as opportunities which could arise. That said, our emphasis would be more to look to the US where we would forecast stronger growth opportunities with a lower risk.

China – will these high metal prices continue? If exports to the USA pick up there is a chance.

China's economy is the second largest in the world, behind the USA, and as such is a hugely significant role player in the global economy. China's GDP growth rate has been slowing for the last decade from a high of 14.19% in 2007 to a forecast 6.7% in 2016, and a further drop to 6.5% being the rough target for the central bank for 2017 (per Goldman Sachs).

As of 2015, the latest available data, China, with 20% of the global population consumed an incredible amount of global resources – some 60% of concrete, 54% of aluminium, 49% of coal, 48% of copper, 46% of steel – and the list goes on.

With 2016 seeing large gains in commodity prices – the Bloomberg Commodities Index was up 11.4% and the Industrial Metals index up 19.5%, we have seen this filter through to the local markets with the JSE Mining Index up 54% and the Resources Index up 26%.

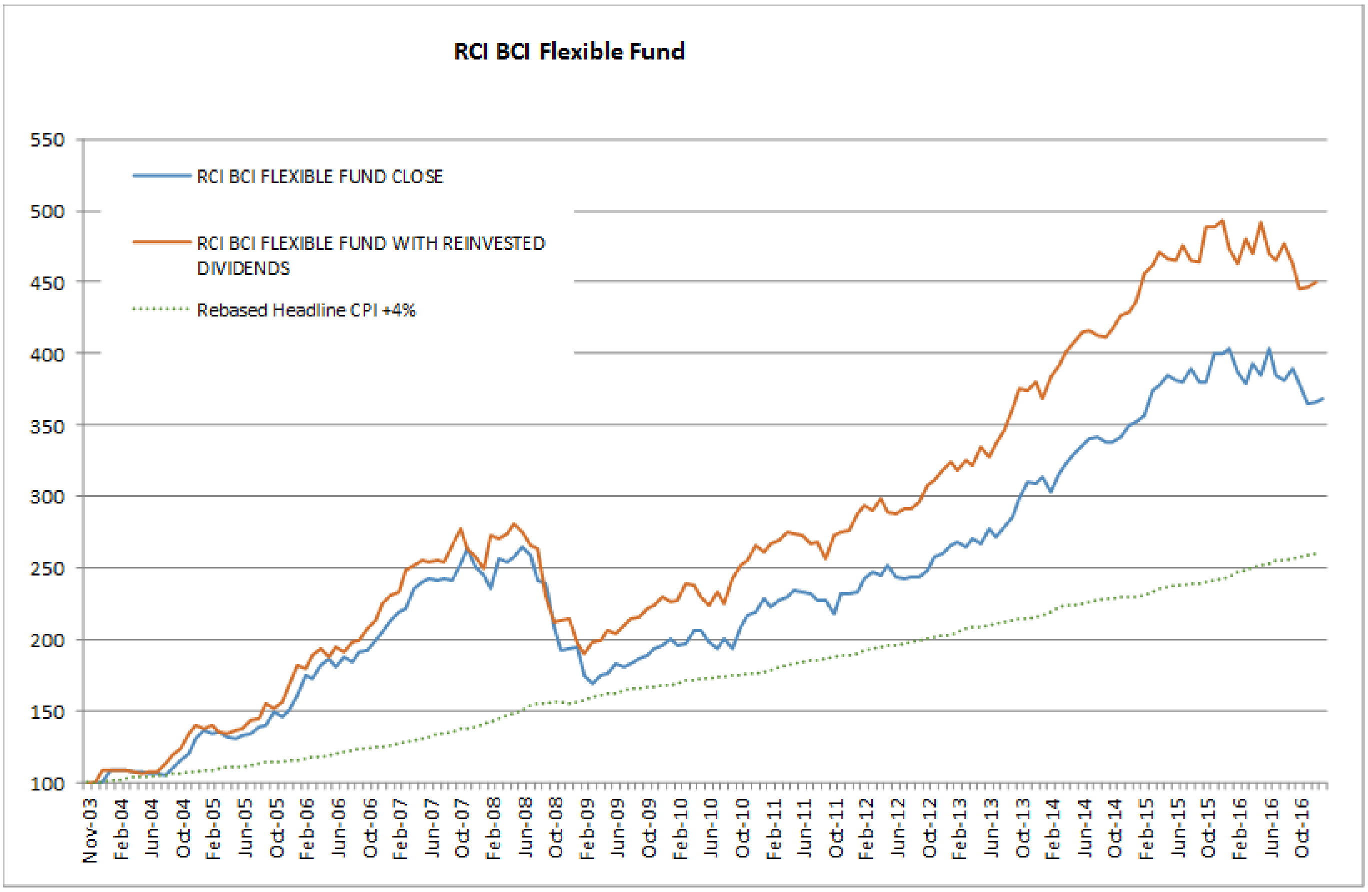
The question remains, given the declining Chinese GDP growth figures and the amount of global commodities they consume, is the 2016 rally in commodity prices underpinned by sustainable demand? Given that the Chinese government is likely to continue to stimulate GDP growth, we hope to see large infrastructure spend continuing. This, together with the touted infrastructure spend by Trump, could see commodity prices continue their rise. If commodity prices just remain at current levels, this should feed through to improved results for the locally listed resource based companies – Billiton, Anglo American etc. This results in more tax being paid by these companies, and in better paid miners, so the economy will slowly pick up.

Our expectation for the year is a 5-10% growth in earnings and similar growth in share prices for both South Africa and the USA, barring unexpected disruptions! This is better than last year!

What were our predictions for 2016 and how did they work out? Please see annexure A.

RCI BCI Flexible Fund – We have slightly underperformed the JSE Overall over 12 months. It is more relevant to compare us with the FINDU 30 as we have eschewed mining stocks because of their risk. The performance was almost identical to this index. Our bet on a weaker rand has not yet paid off, but over three years we expect the rand to be under pressure. Metal prices have had an upward spike but we fear that due to increased world supply, most metal prices are likely to weaken again. We will watch carefully to see if we are wrong.

Please contact Maggie on 011 591 0578 for any help on your unit trusts.



RCI BCI Flexible Fund rose 0.64% for December closing at 368.12c per unit. The JSE top 40 fell 1.37% for December so we out-performed this month by about 2%. Over a year, the Overall Index is down 5.91% and our fund is down 8.30%. That is a 2.39% underperformance. However it is probably more comparable to the FINDU 30 Index which was down 8.27% for the year. We think that this is the bottom and have seen growth of 2% in 2017.

We have set up our portfolio to benefit from a weaker rand which might have a bit of strength in the short-term, now that the downgrade has been avoided and the cash must soon start flowing into South Africa to fund the SA Brews buyout.

Unit trust has flexibility – happy to take small amounts

The unit trust has the flexibility to buy and sell shares and to change weightings more frequently than in an individual portfolio. We are happy to take small amounts into the unit trust (from R1 000 per month or lump sums of R10 000). As you will not pay commission to any agents there is no cost to get in and out of our fund. On selling, the amount you receive back will depend on our performance.

To conclude

2016 was a strange year. Events occurred such as Brexit and the election of Donald Trump that were virtually unprecedented in the last 50 years. Fund managers expecting a weaker rand and weak metal prices ended up wrong in the short terms – but not wrong enough to threaten your long term wealth.

The issues to focus on are your growing dividend stream and the threat of long term loss in your capital. One year price movements are largely irrelevant. Take Naspers, it is already up 7% in 2017, negating almost all its losses in 2016. What are the risks of a long term loss in Naspers? Very low. What are the risks of long term losses in mining shares? Very high. Which way should pensioners bet? Naspers type of companies of course. Can they underperform over any 12-month period? Of course. Can they outperform over five years? Very likely.

As Damon Runyon said "The race is not always to the swift nor the battle to the strong – but that is the way to bet!"

We aim to be the best family office in South Africa.

Thank you for being our clients.

Best regards

Di and Alan

Annexure A

It is always interesting to look back upon a year ago to seen what predictions we got right. Our comments on how matters evolved are underlined. This is what we said:

How we see 2016 unfolding

Most things change slowly and inexorably, driven by the long-term changes in demographics, energy, technology and military power. Some things change suddenly and dramatically**.** Such as Brexit, the election Trump and the resignation of the Italian prime minister.

The USA – the key growth engine being 25% of the world economy. The only game in town?

The U.S. remained, by far the world's largest economy, representing almost a quarter of everything that is produced in the world.

Slowly improving USA with continued improvement in house prices and unemployment should lead to GDP growth of between 2% and 3%. Company profit growth should average around 5% to 10% in the USA but the strong dollar is going to reduce growth in their foreign subsidiaries yet again. The US economy remains fragile with some large

risks and too much government debt but we think they are most likely to muddle through as there is no real alternative. Growth in 2016 U.S. was slower partly due to sectors being increasingly suppressed by regulations?

We expected that the oil price would remain under $60 for the next two years at least. Oil price has rallied over 2016 to about $55 – still below $60 but meaningfully higher. This is going to raise the inflation rate in the world.

We expect the USA to raise rates slowly and carefully. Two 0.25% rises in June and December 2016 are all we expect at this point. Most commentators expected larger increases but we were saying this was unlikely. Only one 0.25% rise actually occurred (in December). We would expect the gain in company earrings to reduce to about 5% in 2016. Many big US international companies earn 30% to 40% of their profits from the rest of the world (think McDonalds or KFC) so their profit growth will remain under some pressure. Companies focused on the US domestic market should do better but those focused on fracking and oil will suffer. Wrong - those focused on oil and fracking would have done well thanks to the surge in the price of oil.

So, again, although the US economy will not be plain sailing, it is virtually the only boat in the race. Valuations, are above average but not wildly so, particularly when compared to the low interest rates available and the longer term risk of losing a lot of money on the alternative, US Government bonds, when rates finally move up significantly. Bond rates finally started to rise towards the end of 2016 after the election of President Trump – the bull run in bonds appears to be over.

American growth will be the engine that powers world growth but metals will suffer in the meantime. Wrong = Some metals almost doubled in 2016 (iron ore). Our biggest surprise was that Metal prices have increased over 2016. We suspect that this is a short term phenomenon as previous metal cycles took about twenty years to turn but we clearly got this wrong in the short term.

Some investors believe that the Chinese economy is going to fall off a cliff. We think that it has enough foreign income, taxation and foreign reserves to put off the evil day for quite a few years. Correct. However, it is likely to have a lower appetite for metals (clearly wrong in the short term) until exports to the USA and Europe finally pick up meaningfully. Most miners have doubled production since 2008 (except SA as we ran out of railroads, electricity and harbours) which has resulted in collapsing metal prices (iron ore is down from $135 to $60 a year ago but only about $38 now) resulting in weak currencies for SA (down 34% against the US dollar in 2015), Australia and Brazil. We see prices and currencies getting worse until the high-cost producers finally cut production (this always takes time for a meaningful effect) and world demand increases. Metal prices and emerging market currencies recovered. Brazil's currency was the best performing currency in 2016.

Developed Markets likely to rise about 5%

Our best guess is that the economic growth will translate into profit growth of about 5% for most large US companies. The continued switch from bonds to shares by investors should result in shares rising about 5%. Of course we could be wrong, the likely range is between -5% and 15%. Interest rates should stay low, resulting in shares remaining good value relative to interest rates. The strategy should be to invest a lot in companies with highly dependable (but probably boring) profit streams until the economy has strongly turned the corner and dealt with its debt issues. <u>Right. The SP500, the premier US Index, rose 7.7%.</u>

The oil price- should remain weak for years. Dissention within OPEC The last time we had such a drop in 1986, it lasted for some time. Oil importers (think Europe, China, Japan and South Africa) greatly benefit. If these economies are battling now, imagine the pain of a high oil price. <u>Price of oil has increased in 2016. Fortunately, the rand strengthened too so the price in rand was not badly affected.</u>

South Africa - the downward drift continues – will government behave?

Two years ago we posed the main question which remains unchanged: Can South Africa hold out until the increased demand for resources translates into better exports or will we see the rand continuing to plummet in the meantime? Continued Middle Class spending is providing momentum to the economy. This has been bolstered by the increase over the past eleven years in the Black Middle Class from 1.6m to 6m. Many of them work for the government or for large corporates and have got used to increases well above inflation increases. Now the government has run out of money, yet still gave them a 7% increase. Is this going to result in further strikes? Over the next few years, this spending should decelerate. A year ago we asked if government workers will behave. Now, we wonder if the government will behave! <u>Reasonable: Mr. Gordhan did a great job in avoiding the downgrade.</u>

We often pointed out between 2009 and 2012 that the rand appeared inordinately strong when one considered all of South Africa's problems but everywhere else was just as bad. As we said last year, 'The release valve to all this pressure is the value of the rand and when the rand weakens, it often overshoots quite badly so there is a risk of a further substantial weakening.' <u>Rand strengthened and managed to hold in 2016 – pick up in commodity prices, SAB deal contributed.</u>

After the shenanigans of three finance ministers in a week in December, the rand may have overshot but the risk of a credit downgrade for the country is looming ever closer. Although there is a possibility of short-term recoupment of 5% of 10%, we expect that the rand will be still weaker in a year's time, let alone in three or five years' which is our normal investment horizon. <u>Rand strengthened and managed to hold in 2016 – pick up in commodity prices, SAB deal contributed.</u> The ability to predict currency movements in the very short term is not a skill to which we aspire. This belongs to the "just too difficult" category.

We have learned over the years that normally, the most sensible way to send funds offshore or to place funds into markets is to average-in over time i.e. to do a number of small amounts spread over years rather than to do it all in one hit. This strategy would definitely apply to transferring of funds offshore at present as we cannot be certain of the short term currency fluctuations. We will continue to monitor the currency and send more offshore when we believe it expedient. <u>Correct – remains the best policy we know of.</u>

President Zuma is going nowhere?

A year ago we said he was going nowhere. Now we are not so sure. After the debacle in December, there must be a good chance that the ANC will consider recalling him after six months or a year, once face has been adequately saved. The succession plan may have gone awry. <u>Mr. Zuma is still in power – as he did not get withdrawn in the first half of 2016, he is likely to stay in power until after the December 2017 elective conference.</u>

The outlook for South African share prices remains difficult

What we wrote last year remains valid: "A year ago it was not difficult to foresee that mining would not be a good place to be. Now we might be close to the bottom of mining share prices but it takes a brave (foolish?) investor to start buying them before they have bottomed out conclusively. A weak rand will cause many non-mining hedges to perform ok in rand terms but not so well in dollar terms as few have exposure to the USA." Retailers are faced with a pressurised consumer (although the lower oil price will help a bit, as will no strikes) and we would still expect a company such as Mr. Price to outperform cash. Correct: Markets were difficult and Retailers took a hit. Wrong: Mr. Price had poor results and was one of the worst performers in the Retail sector, falling 20%

Banks and life insurers suffered a big fall towards the end of 2015, probably due to foreign selling. They are now back to cheap historical values and are on high dividend yields so we want to be well invested in them. Once again, the big growth in government pensions should provide some underlying support as the money has to be invested somewhere. Right: Banks up 28% (plus great dividends). Partly wrong: insurance down 8% but dividends received were about 6%

Drought: for the first time since independence South Africa has suffered a meaningful drought although some US scientists say the weather pattern will alter for the better by the end of 2016. Let us hope so as it already appears as if we are going to have to import 5 million tons of maize (we have lost 30% of our crop) for which we have to find the money and the logistics to do it. Correct -the drought was tough and weather patterns did improve in the second half.

Labour unrest: at the moment, the labour scene appears less troubled than any time during the past three years. If the economy battles, lay-offs may prove tricky. We could get a minimum wage introduced that will help spending but of course hurt the employers having to pay it. Correct: Labour was relatively tame during 2016 and a minimum wage was introduced.

South Africa has many problems but of course, so do the nations competing with us for world attention and capital. Sometimes, as bad as it seems to South Africans, we fail to realise that the competing countries are even worse (thanks Brazil!) and somehow we muddle through. This country has survived many predictions of doom and the odds are that it will survive the current tough times. It is vital, at this point, to be invested in the right sectors, not the cyclical, highly unpredictable ones such as mining or food production. Correct: SA (and Brazil) muddled through exceptionally well in the circumstances. In 2016, the Mining sectors and Food did well but it is seldom worth investing in the when the risk is taken into account.

As we have often commented in the past: When uncertainty reigns it is best to buy great companies with excellent products, strong balance sheets and good management who will react to changing circumstances. But don't overpay. If you are patient, you will normally get a chance to buy when the price dips to more reasonable levels. The past thirty years have taught us that good companies will find a way to progress even when times are tough. Be patient, this is a five- to ten-year game, not a twelve-month game. We reiterate: be patient!

We continue to favour a portfolio split 50/50 between offshore investments and local (with plenty of rand hedges in the latter). If the rand drops substantially or value returns to local shares, it can then be rebalanced. As usual, we are in for an interesting year. In 2016 the rand was remarkably strong and the value of offshore investments dropped. This does not make the policy wrong! Unless, stupidly measured over 12 months.