# Robert Cowen Investments

Growing families' wealth since 1982

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# Newsletter

end November 2016

13 December 2016

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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

"Good friends, good books, and a sleepy conscience: this is the ideal life."

~ Mark Twain

**RCI MET Flexible Fund** – closed November at 365.63. This was a paltry 0.22% up for the month. It is 8.18% lower than 12 months ago. The JSE Top 40 was down 0.75% for the month and is down 9.57% 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 FINDU 30 Index which was down 11% for the period.

Despite this inconsequential 12 months, we are still up 6.48% per annum over the past three years where we ranked 45th out of 76 funds. So why this minimal under performance over the past year? We have been surprised by the strength of the rand over the past six months and were scared of political turmoil in South Africa. The rating agencies have given us a stay of execution for at least six months but the economic outlook for the country remains tough.

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

**We wish all our clients a blessed Christmas and a very happy 2017.**

As someone once famously said, "the future had better be better than the past!". So closing out on a tough year for investments, we look forward to a better year in 2017.

**In this letter we explain to you why we prefer to invest in Standard Bank** which is up 53% since its bottom in January compared to Anglo which has rise 287% since then.

Over ten years, Anglo has fallen by 37% (and its dividends have collapsed from a paltry 1.73% to zero) whereas Standard Bank is up 60% and its dividends have grown at about 10% per annum to 6.4% on the opening price! So in 2016, this strategy has caused us to underperform but over 10 years we have shot the lights out and provided you with a safe growing dividend stream.

## Objective: A good return at an acceptable risk

Amateurs say “Big risk, big reward”.

Professionals should say “Big risk = big loss (or risk thereof)”. Professionals want to get the risk of losing permanent capital very low. When prices of shares get very low, the opportunity rises but the risk falls. If a share is priced at R2, there is a theoretical risk that an investor can lose R2 but if the price falls to R1 before the investor buys it, then the most he can lose is R1.

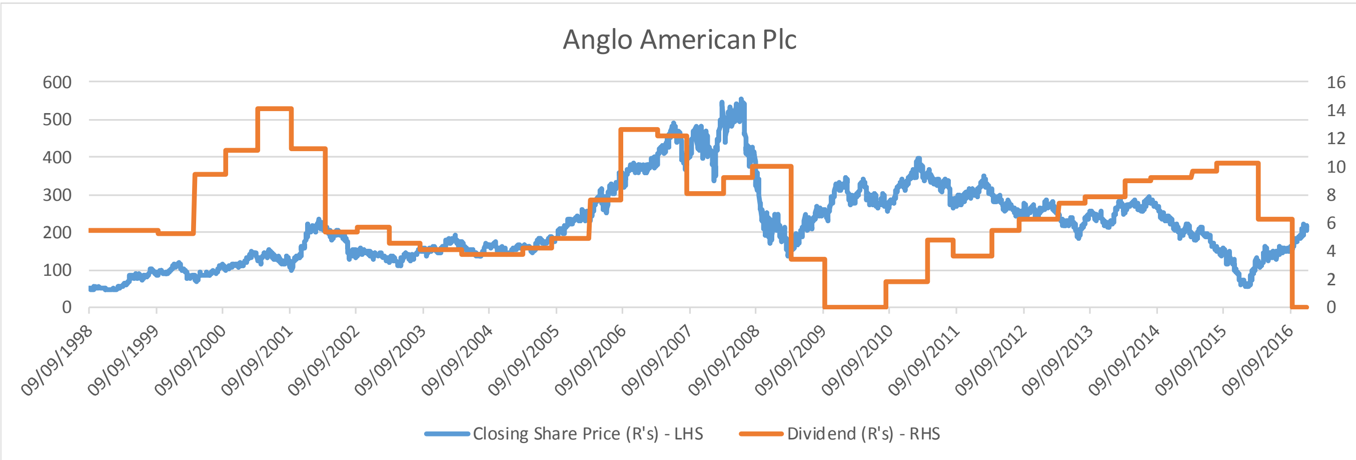
In reality, unless a share is in a very cyclical industry (such as mining or car sales) the price is most unlikely to go to zero, no matter how bad the conditions. We are trying to buy a share at R1 that MIGHT fall to 70c first but can go up to R3 in the next three years.

So how do we achieve our goal?

I asked Andrew Lawson to pull some graphs and to write this explanation:

One of the main investment philosophies we follow at Robert Cowen Investments is to invest in companies which have reliable underlying earnings, and historically portray increasing and reliable dividends throughout the various economic cycles. The graphs below show the share price movement (in blue) and the dividends paid (in orange) of Standard Bank and Anglo American Plc from 1998 to 2016. The Anglo American graph shows the volatility in both the share price, as well as the dividend stream. To give some perspective to the two graphs, had you been invested in Anglo American your capital value would have grown by 320% whereas an investment in Standard Bank over the same period would have grown 1015%. When one requires dividend income for drawings to support living expenses, it is clear from these graphs that you would much rather have been invested in Standard Bank over the longer term – current dividends on an initial investment in 1998 would equate to a 51.90% dividend yield. Anglo currently pays no dividend, and any source of income would have disappeared! It is true that during this period there are certain times when Anglo would have outperformed Standard Bank, but the old adage of “time in the market is more important than timing the market” is clearly evident. This highlights the importance of always remembering the longer term investment goals.

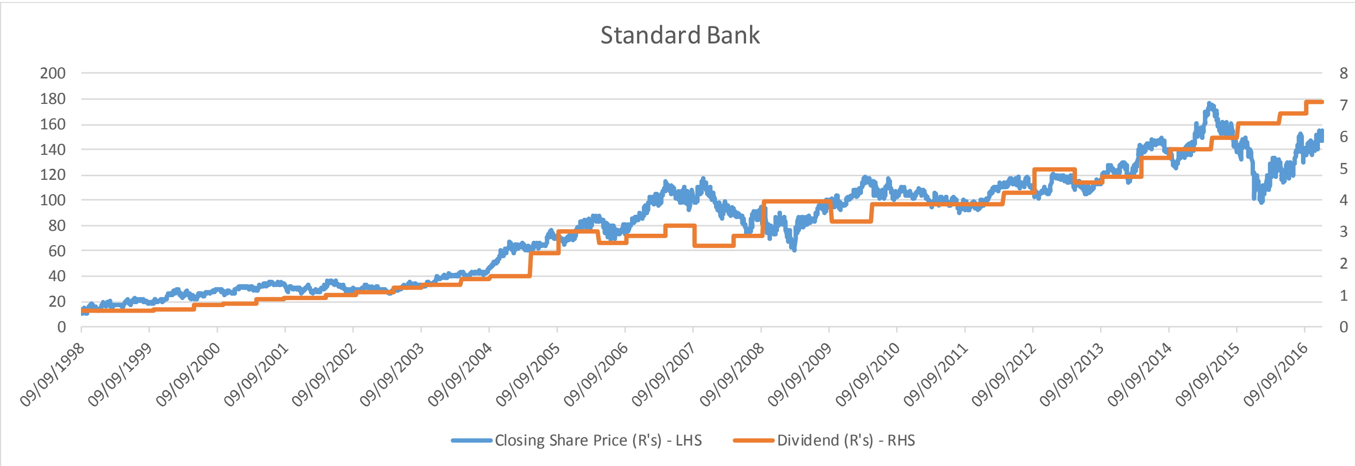
**Anglo American – share price and dividend history since 1988**




Source: ShareFriend and RCI

Note the erratic share price. Even more notable is the jump in dividends from 200 to over 500 and then a collapse in recent years to zero.

**Standard Bank: Share price and dividend growth since 1988**




Source: ShareFriend and RCI

Please note that Standard Bank has increased its dividend every year. It is only the split between interim and final dividends that sometimes gives a confusing pattern. Note the overall pattern of steady, reliable dividend growth.

**Why we tend to avoid mining shares**:

The following graphs illustrate what we are trying to achieve. The first graph is that of Anglo American. Unlike Andrew, we have just shown the past ten years.

**Anglo American share price over the past 10 years**


Source: ShareFriend

Dividend growth was strong from 2004 to 2015, then the share price collapsed when the dividend was cut to zero in 2015. The blue line shows the erratic share price which collapsed by 37% from R334 to R212 over the ten years. It is evident that one can make a lot of money if you get the trend of this share price correct. Note how it rose by 60% in 2007 and 2008. BUT also remember the risk. At the current spot prices of the metals Anglo produces, income should rise nicely. Thus the share price could rise nicely too. However, no one knows if the demand for metals has turned the corner upwards again for the longer term. Prices of iron ore in China have jumped. The optimists say it has bottomed out. The pessimists say the upturn can only last for a few months as it was caused by a shortage in China and problems with the Australian producers, both of which will be resolved shortly. In favour of the argument of the pessimists is an oversupply of iron ore which should take ten years to resolve. The history of the metal cycle from the 20th century is that after a boom comes a 20-year bust - why should it be different this time?

We think it is better to work with the probabilities in our favour. We will only be convinced of mining when the fundamentals turn firmly in our favour. What happens when Anglo cuts its dividend? Where do you then get the money to live on? You have to sell some of you shares at the bottom!

**Things to note about Anglo American**

1. The share price started at R334 ten years ago. This was the middle of a metals boom and it rose 60% to R548 in 2008.
2. It then collapsed and by January 2016 was right down to R54 – a loss of about 90% from the peak!
3. From January 2016 it has risen by 287% to R212 – a phenomenal rise.
4. Despite this rise, it is still down 37% over the ten years.
5. The dividend 10 years ago was 1.73%. The dividend now is ZERO with the hope that they might start paying dividends in a year. So what do you live on in the meantime?
6. Investing in Anglo requires that you get your timing absolutely spot on, or you will lose your shirt!

**Why we like banks**:

The next graph shows Standard Bank. Andrew's red line shows the steady dividend. Standard has never cut its dividend in over 40 years! It is on this dividend that you can rest assured to give you income to meet your food, chemist and doctor's bills!

Over the medium terms, the share price follows the dividend. So although the long-term trend in the share price is nicely up – over 200 times in the 30 years that I have been analysing banks, there are periods when it underperforms – such as now. As long as you are not a forced seller when the share price hits a bottom, there is no reason for concern – it always comes up again. It is as if a rubber band is stretched downwards. When it is released, it shoots up and nearly always over compensates on the way up. Then reality sets in and the price drops again. However, may I remind you that the trend over the long-term is convincingly up?

To make you good money, your fund manager must not panic out of Standard Bank at the bottom (it was a disaster if he sold in January 2016 at R100). Now the price is back up 53% to R153 and it has paid you two handsome dividends while you held it. Thus, we are trying to find you shares in great companies that offer you good value and little risk.

We believe that by investing most of your capital in companies with high returns on capital and good cash flow, we can reduce your risk without substantially reducing your gains in share price. We cannot change the whole portfolio each year as SARS would then want to tax you as a share trader. We do not usually like to change more than two of the shares in your portfolio of about 16 shares.

**Standard Bank share price over the past ten years**


Source: ShareFriend

This strategy is not without its worries and concerns, but it is generally the best way to invest. It is still volatile but you only lose about half your money opposed to 90% in Anglo American.

Have a close look at the Standard share price graph of the past ten years. It started at R90 and rose to R116 in 2007. It then crashed 48% to R60 in early 2009. Then over the next seven years it rose all the way to R172 in 2015. Then it crashed 43% to R99 in January 2016. Now it is back to R153 – a 53% rise, back now to its long-term historical value.

So the things to note about Standard Bank are:

1. The price overreacts to both the upside and the downside.
2. It is up 60% over the ten years.
3. The trend is erratic but generally up.
4. The worst thing to do was to sell at the bottoms. It was sometimes a good idea to sell a bit when the price had run very strongly.

Throughout the 10 years, the dividends grew strongly - up by 109% thus about 10% per year, when the inflation rate was less than 5% p.a. This is what will give you the steady growing income that you need.

**Conclusions:**

By being in steady growing stocks, you have gone up 60% over ten years. Your dividends have grown by about 10% per annum. The share price has often been erratic but you could happily buy and hold – unless you bought at a peak. Anglo American has risen over 200% this year - causing us to underperform in 2016 as we did not have any. Does short term underperformance matter? Over 10 years it is down 37% and the dividend has disappeared. It is essential to buy Anglo at the bottom of a crash and sell it at a peak. The trouble is, no one knows when it is a trough or a peak! Furthermore, there is huge risk that the fundamentals will be poor for the next ten years. So why go there?

## R132bn outflow out of South African shares and bonds yet the rand is so strong

It is fascinating to see that non-residents sold R118bn of shares and a net R14bn of gilts for a total outflow of R132bn. (Source: Citibank 9 December 2016). Despite this, the rand has been so strong this year. Why? Partly, these outflows were offset by the huge inflow for SA Brews. This deal finished two months ago and one would expect the local banks to have been short the rand to fund the deal but, over two months later, this should be pretty much over.

So have all the non-residents who wanted to sell finished? We hope so, otherwise large sales will result in a weak currency in 2017. Many commentators are expecting a stronger rand in 2017, much of their reasoning is based on the higher metals price of the past two months.

Above is the price of SA's largest export -Iron Ore (Source: ShareFriend) over the past five years. It is significantly higher than the $40 that it finished 2015 at but the current $60 is less than half f the price before 2014.

Other graphs show it jumping to $73 in the past few weeks. Some commentators believe that the price rise is due to a shortage at Chinese ports, aggravated by delivery problems from Australia. They expect the price to fall back again. Others say, NO, the Chinese demand is picking up again and that the price of iron ore will be strong, even when production is restored. We have previously shown you how the metal cycles of the 20th century took an average of 20 years from the peak cycle to the beginning of the next cycle. E.g. gold peaked in 1980 and in took until 2002 for the next up cycle to begin. As the cycle peaked in 2012, it should take until about 2032 for the next metal cycle to START. This is supported by the 25% oversupply currently in the world and the drop in growth to 3% for the demand from the Chinese for Iron Ore. The Chinese are using half of the world's iron ore and the rest of the world is growing at 1% so that is an average growth of 2% per annum. Possibly Trump will get the USA to grow infrastructure but even his best efforts is unlikely to increase demand by more than 0.25% per annum. Thus at the moment, we have to stay with the argument of the pessimists – that iron ore prices are probably having a temporary spike.

## The power of compound growth in dividends

Ross McConnochie

The growth rate in dividends is just as important as the actual dividend yield one can receive from a company. This is because a company that may pay a large dividend but has very little growth in the dividend may not be ideal over the long run as its dividend may not be sustainable. But a company that pays a small or medium dividend but is growing that divided at a rapid pace could become a large dividend yield in the future or the share price may grow with that dividend growth and you would get excellent capital growth.

Here are some great global companies that pay growing dividends:

| | Current Forward Yield | Long-Term Growth Rate in Dividends |
|---|---:|---:|
| Microsoft | 2.7% | 14.7% |
| Roche | 3.8% | 14.0% |
| Imperial Brands | 5.0% | 11.7% |
| Colgate Palmolive | 2.4% | 11.2% |
| Phillip Morris | 4.8% | 10.3% |
| Nestlé | 3.5% | 9.4% |
| Procter and Gamble | 3.3% | 9.4% |
| Pfizer | 3.9% | 6.9% |
| Unilever | 3.4% | 6.1% |
| General Electric | 3.1% | 2.4% |
| Average | 3.6% | 9.6% |

A portfolio of the above shares would produce an excellent forward dividend of about 3.6% for the next year but what is even more interesting is the long-term growth rate in the dividends. Over the last 7-15 years the above shares have managed to grow their dividend per share at an average rate of 10%.

| | 31 Dec 2011 price | Dividend Yield on Cost Price |
|---|---|---|
| Microsoft | 2596 | 6.1% |
| Roche | 159.2 | 5.6% |
| Imperial Brands | 2435 | 7.1% |
| Colgate Palmolive | 4619.5 | 3.5% |
| Phillip Morris | 7848 | 5.4% |
| Nestlé | 54 | 4.5% |
| Procter and Gamble | 6671 | 4.2% |
| Pfizer | 2164 | 5.8% |
| Unilever | 2163 | 5.0% |
| General Electric | 1791 | 5.3% |
| Average | | 5.3% |

If you purchased these shares five years ago you would have a current average dividend yield on your original investment of over 5%. And because the yield today is lower than it was five years ago this means you have had very nice capital growth over the past 5 years. So not only were you paid nicely every year through growing dividends but your capital has appreciated too.

This is an important part of our portfolio construction as one can achieve excellent long term investment returns if you purchase good companies at reasonable prices. At RCI we aim to buy companies with the following characteristics.

1. International branding
2. Strong balance sheets
3. Large market cap stocks
4. Primarily listed on developed market stock exchanges
5. Defensive in nature
6. High dividend yield
7. Taking advantage of growth in emerging markets

Shares on our watch list include pharmaceuticals, personal goods, retailers, food, beverages, tobacco and alcohol. We are particularly interested in companies with products that people have to purchase on a day to day basis. Over time, they should show good capital appreciation but what is essential is that they should pay a growing dividend well in excess of the interest rates that can be earned on cash deposits.

## The relationship between Dollars and Rands

Ross McConnochie

The rand dollar exchange rate has a massive impact on all our lives. Even the man on the street relates to its effect on everyday prices. But how exactly does the relationship work? What factors affect it? Here is a simple economics 101 lesson on exchange rates and how they are influenced by central banks, investor sentiment and government intervention.

The currency relationship is based on a few fundamental differences between nations. They are, all else being equal:

The difference between inflation rates – The currency of the country with the higher inflation will weaken.

The amount of money that is in circulation - The country putting more money into circulation will weaken their existing money because there is more money but the same amount of assets.

The trade deficit – the current account = the country importing more than they export reduces demand for their own currency. The Capital Account = The country with large direct investments will strengthen.

The purchasing power of the people – "Bang for their buck" where people should be able to afford the same goods and services with their equivalent incomes.

Speculators and Hedgers – Investors betting on the future outcomes of the currency and how these other factors may change in the future.

The rand has sadly failed on all the above measures and thus the relationship between dollars and rands should continue to worsen over time.

The rand is a floating rate currency – It is not pegged to any other currency. You are able to trade on currency markets according to supply and demand. In fact far more rands are traded per day due to speculation than for currency that is needed to complete international deals. Investors are merely betting on its future price. Thus we often see the rand dollar fluctuate drastically at times because of these market players. They would also sell rands now, including rands they don't currently own in the hope that they can buy it back cheaper in the future, if they thought that any of the below factors are expected to deteriorate more than average:

Purchasing Power Parity:

We use money to purchase goods and services and therefore what you are able to purchase with rands should be very similar to what you can buy in dollars if you were earning dollars. Consequently, the relative cost of goods should be very similar across countries. This is called purchasing power parity (PPP). If it costs R30 to produce a Big Mac in South Africa and $3 in the USA for that same item it should be approximately R10 to the dollar. In fact there is something called the Big Mac index which compares this relationship across various countries creating a rough estimate of the purchasing power of various economies and consequently the implied exchange rates around the world.

The reason why this relationship exists is because if a country had identical goods currently trading at a cheap price due to the weak currency then other countries would import goods from that country (demanding rands) until the currency strengthened and the goods were no longer cheap. So in simple terms if our rand got too weak the rest of the world would simply import all their Big Macs from us instead of buying them in their own county and thus increasing the demand for rands and strengthening our currency. But of course in the real world they would all go stale during the transport! Or would they?

Inflation Differential:

One of the main factors effecting the exchange rates is South Africa's inflation versus America's. Ours has been on average about 6.8% per year since 1991 and America's 2.5%. The difference between this is called the inflation differential and it has been an average of 4.3% over the past 24 years. What this means is that South African goods and services have been getting 4.3% more expensive than America's every year and consequently our currency must depreciate at least by the differential all else being equal. So quite simply if Big Macs are getting more and more expensive in South Africa vs America then less Big Macs would be exported from South Africa and the currency would weaken over time. This is why central banks try curb inflation by increasing interest rates, leading to reduced spending in society (which hinders economic growth but we aren't getting into that discussion here).

Money Supply/Monetary Policy:

The next issue is the amount of rands there are in circulation. If our central bank, for example, suddenly doubled the amount of rands in the economy whilst the country's assets remained the same then every rand would be worth half as much. So the monetary policies set by our reserve bank also play an important part. If they are placing more money into circulation (which they continually do) our purchasing power dwindles and consequently our currency weakens. Another way of looking at it is if there is an increased supply of rands with the same demand for rand by Americans then the price will fall (currency depreciates).

Demand for Imports vs Exports:

Another factor is South Africa's demand for imported goods vs our exported goods. This is called the balance of trade account of the country and South Africa runs a deficit year after year. Therefore there is a greater demand for other currencies than there is for rands because we are importing so much. Thus South Africans are supplying more and more rands in exchange for dollars and the currency depreciates.

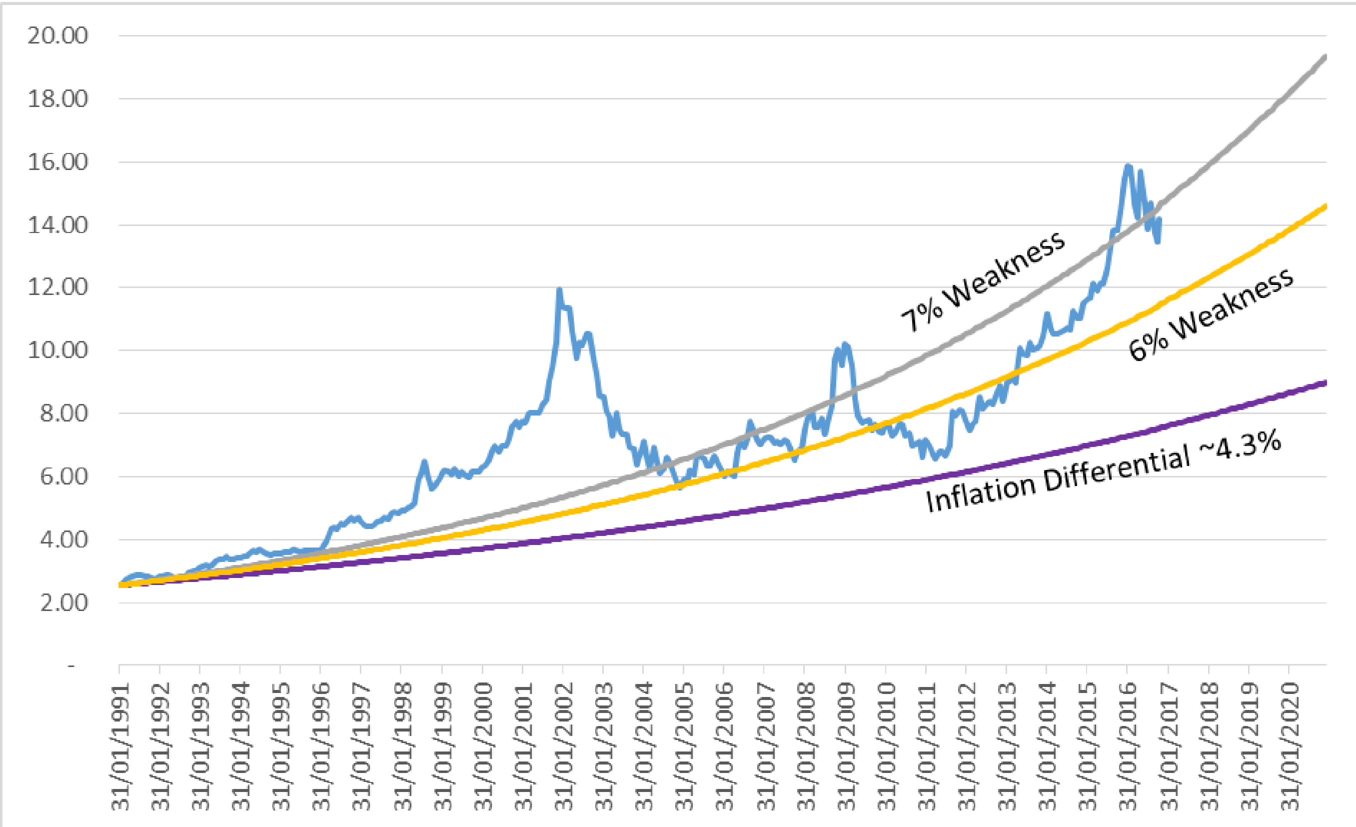
Foreign Direct Investment:

If foreigners are net investors in our economy they will strengthen our currency. The opposite is true if they are scared off by our politicians and want to sell their South African assets.

Speculation/Hedgers:

An important element to all the above is sentiment on the open market for currencies. If people or organisations that hold rands, suddenly have a negative or positive view on the future of the country that they believe would eventually cause changes in the above factors, they may buy or sell rands now in hope of taking advantage of those changes in the future. There is a relationship between what people think the future of a currency is compared to what will actually happen. If some speculators believe that South Africa's inflation is expected to double over the next few years then they certainly wouldn't want to hold rands with the view that it will depreciate considerably in the future. They would thus sell their rands in the open market now and alter the current exchange rate.

Ok, enough with the lessons. Let's take a look at the relationship in a graph:



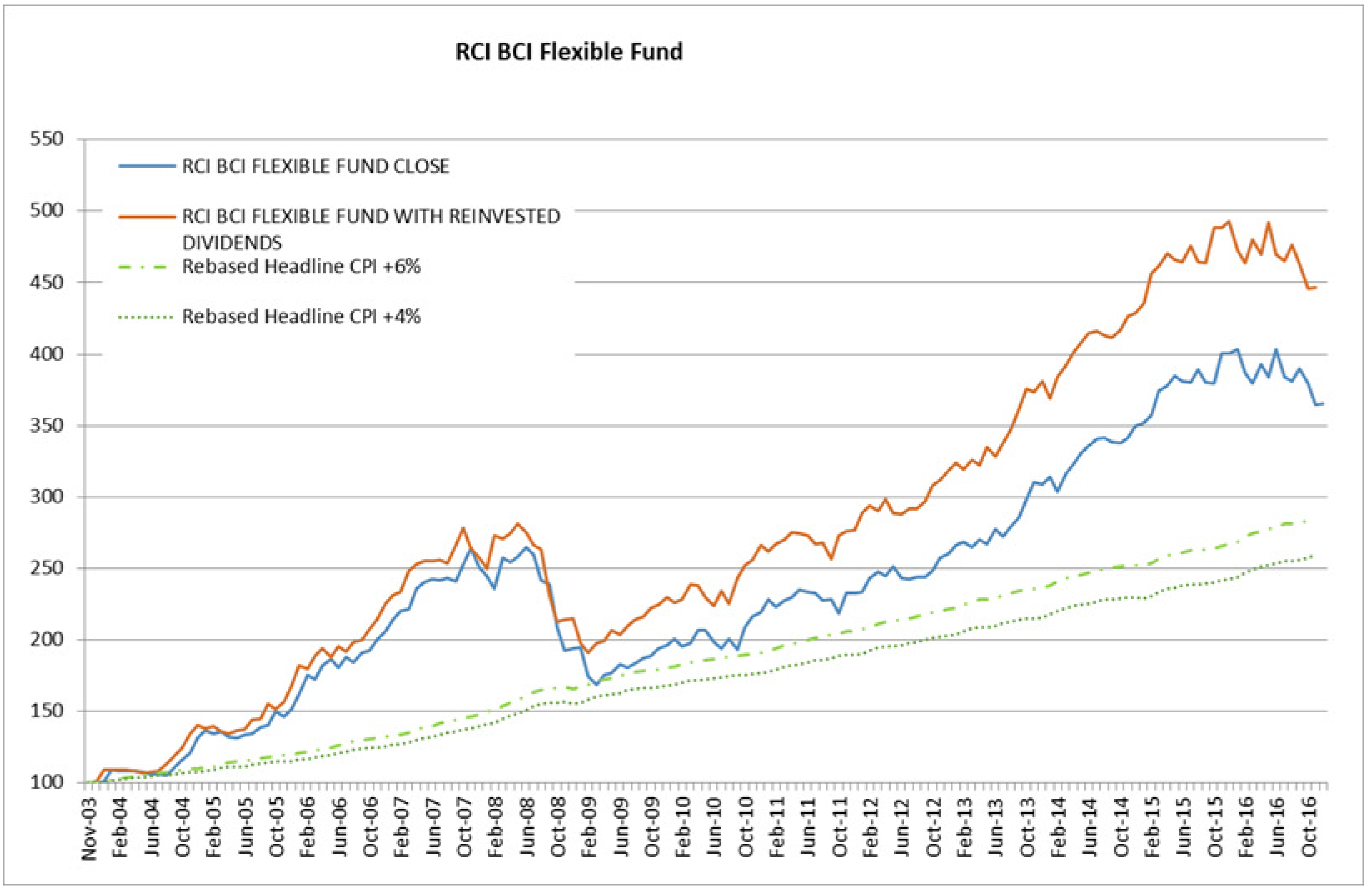
The blue line is the actual year end rand dollar relationship since Jan 1991. We can see how it blew out in 2001 (Terror attack) and 2009 (financial crisis); as well as how it strengthened during the metal boom and then weakened over the past several years just to blow out at during the Nene debacle. The long term weakness has been approximately 6-7% on average every year which we have graphed in the orange and grey lines.

The purple line is the differential between South Africa's inflation and the USA's. It depicts what the rand would be relative to the dollar if all the other factors remained constant i.e. constant monetary policy; balanced current account and constant purchasing power parity. We can therefore loosely deduce that the difference in the average actual weakness of the rand (the orange/grey lines) and the inflation differential (purple line) is due to the other factors discussed above: Increased money supply; current account deficit; weaker Purchasing Power Parity.

Sadly South Africa does not seem to be improving any of the factors that affect the currency relationship and thus we could extend the trendlines of 6-7% average weakness into the future creating a rough forecast of what the future may bring. Yes we could see short term strength in the rand but without material improvements in our economy that strength would be short lived. This is one of the main reasons why we encourage our clients to invest some of their assets offshore where they can take advantage of companies with excellent balance sheets that pay dividends far in excess of interest rates all in none rand denominations thus hedging any weakness we may have in the future of our currency.

**RCI BCI Flexible Fund – We have slightly outperformed 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. 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 a sudden upward spike but we fear that due to increase world supply, most metal prices are likely to weaken again.**

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



RCI BCI Flexible Fund rose 0.22% for November closing at 365.63c per unit. The JSE top 40 fell 0.75% for November so we out-performed this month by about 1%. Over a year, the Overall Index is down 9.57% and our fund is down 8.18%. That is a 1.39% outperformance but is, of course, to us, disappointing! 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**

"The greater our knowledge increases, the more our ignorance unfolds." ~ John F. Kennedy

2016 has been a strange year. Starting off with rand weakness following Nenegate, the rand has been remarkably strong. South Africa avoided a down grade in terms of its credit rating. We have been warning of this for years but no action was taken until the last year. We are afraid the word 'avoided' may simply turn into 'delayed' but it gives us a year or two's grace for the rand.

We like this newsletter because it explains why we prefer a company such as Standard Bank over Anglo. We like to buy shares with high returns on capital employed, high cashflow and high and growing dividends to provide steady income while we wait for something good to happen. In the short-term i.e. in 2016, mining has outperformed but we illustrate how, over ten years, Standard Bank has been so superior.

We are aiming to get you, our clients, most of the upside but at much lower risk.

We wish you all a wonderful festive season and a spectacular New Year!

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

Thank you for being our clients.

Best regards

*Di and Alan*