Robert Cowen Investments

Growing families' wealth since 1982

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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

"Being deeply loved by someone gives you strength; loving someone deeply gives you courage." ~ *Lao Tzu*

RCI BCI Flexible Fund – closed December at 372.79, down 7.05% for the month. The Fund rose 1.93% for 2017. The rand strength caused by Mr. Ramaphosa winning the election is affecting our favourite shares but we think he will struggle to turn things around quickly and SA might be downgraded after the Budget.

RCI BCI World Wide Flex closed December at 101.87, down 6.84% for the month but up 1.25% for 2017. What really matters is how is this fund doing in dollars? It rose 13.4% in 2017 which we were very happy with. This unit trust is invested in about 20 world-class companies. Most have a very high ROCE. Many are household names such as Nestlé, Apple, Microsoft, Johnson & Johnson. The growth in dollars has been good over the past year so when the rand weakens, we expect the performance to be good over five years.

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

What do we expect for 2018?

The vast majority of our clients have retired so cannot make back permanent losses, which we seek to minimise. Most clients have 50% invested offshore and had about 3% of their local portfolio invested in Steinhoff. Thus, their loss in total terms was about 1.5%. Not at all nice, but not the same as losing on a big investment! We are re-examining our processes to try to prevent a recurrence.

We seek to buy shares in solid, growing companies that have limited risk of permanent losses. Naspers has been a great example and we are considering switching some of client holding into a unit trust purely to reduce excessive exposure to one share.

We discuss the implications of Mr. Ramaphosa winning the ANC Presidency. Two of the rating agencies already consider South Africa as junk and the third has delayed its decision until after the budget at the end of February. Whilst we are encouraged by his victory, he has many factions to reconcile and may not be able to deliver what 'business wants' and he cannot single-handedly change the poor metal prices.

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

We like shares that should do well over five years – a one-year underperformance is largely irrelevant, Naspers fell 5% in 2016 but rose 70% in 2017. What will show great growth over the next five years, without much risk? If the company pays a good solid dividend at least you have something to live on while waiting for share prices to recover.

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!

The point of an annual forecast is not be right (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. Therefore, we seek to minimise permanent losses. Steinhoff ended up a permanent loss and we are reviewing our processes to minimize the chance of a recurrence. Most clients have 50% invested offshore and had about 3% of their local portfolio invested in Steinhoff. Thus, their loss, in total terms was about 1.5%. Not at all nice, but not the same as losing on a big investment!

We seek to buy shares in solid, growing companies that have limited risk of permanent losses. For example, what were we saying about Naspers, one of our clients' biggest holdings, a year ago when it was down by 5% during 2016? "We believe that Naspers will go to over 3000 (from 2000) over the next three years. *(It hit 4000 before ending at about 3500)*. 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." We are currently considering a transfer into a unit trust for Naspers, mainly to reduce the risk of such a large exposure to one share, not because we think there is something wrong with it.

Naspers – great rise in 2017 despite the December weakness - unlikely any threat of long-term loss

It is much more important to WIN on Naspers which was about 12% of your portfolio at the beginning of 2017 than to LOSE on Steinhoff where we had about 3% of your local portfolio invested. An increase of 75% on 12% invested in Naspers resulted in an increase in total value of the portfolio of about 9% whereas an 80% drop in Steinhoff on 3% resulted in about a 2.4% fall in the local portfolio and about a 1.2% fall in total wealth.

Mining finally broke its relative downtrend during 2017 but we remain concerned over the poor longer-term outlook for metal price. The performance since the relative graph turned up in mid 2017 has been somewhat mediocre.

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

From 2008, Resources had been a relatively bad place to invest 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. We have told you, *ad nauseum*, about the 20 year cycle in resources which should finally turn up around 2032, so any investment therein should be viewed as short term.

In the second half of 2017, the Resources 20 graph broke the red down-line relative to the JSE Allshare so we bought some resources in the unit trust where buying and selling does not cause any tax issues. We are long-term, low risk investors so it is prudent to wait for this downtrend to be broken.

We had also feared that the rand might get weaker in 2017, particularly if a downgrade of South Africa by the rating agencies took place. The downgrade was avoided, for now anyway, and the rand strengthened on the news of Mr. Ramaphosa winning the ANC Presidency. Two of the rating agencies already consider South Africa as junk and the third has delayed its decision until after the budget at the end of February. Whilst we are encouraged by Mr. Ramaphosa's victory, we would point out that he has many factions to reconcile and may not be able to deliver what 'business wants' and he cannot single-handedly change the poor metal prices which are aggravated by a massive oversupply in the world.

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 to put huge pressure on our economy. 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 2017. The ANC election was 'too close to call' with a minimal winning margin. In any event, we could not sell your entire portfolio and reinvest it into more financial and industrial 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.

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!

The detailed outlook for the world in 2018

(What were our predictions for 2017 and how did they work out? Please see annexure A.)

By Byron Keet, Eric Lappeman and Andrew Lawson

Once again, it has been proven that one should expect the unexpected. The world survived Trump's first year in office while the S&P soared 18% for the 2017 calendar year. US markets have continued to make new highs into the start of 2018. The UK is showing signs of stabilization while it works through Brexit (which is taking longer than anticipated and could end up with another referendum). SA is starting to exude a sense of optimism with new leadership, in the form of Mr. Ramaphosa, at the helm of the ruling party. Many factors have changed since the end of 2016 so let us have a look at some of our thoughts on where we are headed in 2018.

South Africa – Ramaphosa is the new President of the ANC but can the downgrade still be avoided?

2017 brought much political risk and uncertainty with the power struggle between the Zuma and Ramaphosa factions. SA entered a recession despite metal prices remaining relatively strong. We experienced two cabinet reshuffles, including a new finance and deputy finance minister as Pravin Gordhan and Mcebisi Jonas were removed. This, along with deteriorating economic indicators (record unemployment, increasing budget deficit etc.), led to S&P and Fitch downgrading SA to 'Junk' status. Of the three ratings agencies, Moody's has held off on downgrading SA while it looked to the ANC Elective conference in December 2017 and the budget speech in February 2018. Mr. Ramaphosa's victory has been warmly received by all investors (local and abroad) as a sense of positive reform is now in the air. Time will tell how much change he can enact with what seems like a very divided party. In the interim, Moody's awaits the budget speech before making their decision and, although things are looking positive, we do not foresee a major improvement from what was revealed in the mid-term budget speech given in October 2017. SA will still be running a substantial budget deficit and debt levels will remain elevated, albeit that there is now a sense of optimism in the air. In addition to the economic fundamentals, political issues such as Zuma's exit, and the new proposal for free education funding, still need to play out. Should Moody's also downgrade SA to junk, which remains a possibility, this should cause an outflow from our bond market and weaken our currency, as foreigners become forced sellers of our government bonds.

The Rand has however, continued to strengthen on the back of positive carry trade flows in the search for yield around the world, together with the positive view of Mr. Ramaphosa's victory in the ANC presidential race.

We expect the rand to continue to strengthen in the short term as foreigners continue to search for high yield in a country with improving prospects.

Mr. Ramaphosa's election as ANC president should be positive for SA-centric companies as the country looks to a growing economy going forward. Change, if any, will however take time and we need to bear in mind that Mr. Ramaphosa still has no control over the metal prices (with SA still being a quarry to the middle east). That said, if the rand continues to strengthen and the local economy picks up, we would expect to see growth in the banks, insurers, retailers and local property counters. Most of these sectors have already had a solid bounce last year and into 2018. We could continue to witness increased improved sentiment towards these sectors as investors switch out of rand hedge industrials and into 'SA Inc' shares. The question is, if the SA consumer is still under so much pressure, is the rally in those sectors correctly predicting an increase in earnings? We think there is likely a longer lag effect on the improved earnings of these businesses and the recovery in the economy.

Another factor that could drive the rand to strengthen further in 2018 would be any signs of Zuma stepping down early. Zuma still has many supporters within the ANC, with three of his supporters sitting in the new NEC 'top 6'. Will Mr. Ramaphosa allow him to see out his term? More importantly, how will the ANC fare in the 2019 elections if it remains as divided as it currently is?

In general, a stronger rand, stable inflation outlook and stronger than expected commodity prices all indicate both the consumer, and the economy, could be in a much healthier position looking forward.

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

The U.S. is still, by far, the world's largest economy. In nominal terms, it represents almost a quarter of everything that is produced in the world.

A slowly improving USA, with continued improvement in housing prices and unemployment, should lead to increasing GDP growth in 2018 of between 2% and 3%. We expect company profit growth to average around 5% to 10% in the USA in 2018. Most of the re-rating of US stocks has already taken place last year so it is unlikely we will see similar levels of returns into 2018, but we do see the market rally continuing to an extent.

The weaker US dollar helps translate foreign earnings into more USD earnings for most big multinational US based firms. In addition to this, any of Donald Trump's tax reforms should help boost US profits (whether it be reducing income taxes and thereby increasing consumer spend, or imposing reduced tax rates for companies to repatriate offshore profits). The one caveat to the recovering US economy is the ever-growing mass of government debt, but we think they are most likely to muddle through this as inflation picks up over time and they can repay the debt with 'cheaper' US dollars.

We expect the US Fed to continue raising rates slowly and carefully. The authorities are not going to risk curtailing any growth that has taken so long to achieve, especially after having gone through the 'GFC' (Global Financial Crisis) in 2008. This upward trajectory of interest rates should, theoretically, help strengthen the US dollar, but the rest of the developed world is on the same path (and at a faster pace), which could see the dollar remain weak on a relative basis. Many big US international companies earn a significant proportion of their profits from the rest of the world (e.g. McDonalds or Microsoft) so their profit growth should now be boosted by the weaker dollar.

In general, valuations in the US are above historical averages, but not wildly so, particularly when considering the very low interest rate environment (making cheaper debt available for the consumer and companies and future cashflows worth more in present value terms). In addition to this, there is still a lot of liquidity sitting on the side waiting to find a home – this could flow into equities. As interest rates continue to rise slowly, you should also find some funds flow from US Bonds into US equities, as a bull market in bonds comes to an end and investors take profits.

Our strategy at RCI for 2018

We continue to invest most of your funds into companies with highly dependable earnings streams that should translate into solid dividend growth. While equity prices can fluctuate in the short term, your income stream should continue to grow with less volatility.

Themes that we are looking to expose the portfolios to in 2018 include:

- Artificial intelligence
- E-commerce
- Internet of things

These themes are in addition to the usual consumer staples included in the portfolios.

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-two 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.

RCI Unit Trusts

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

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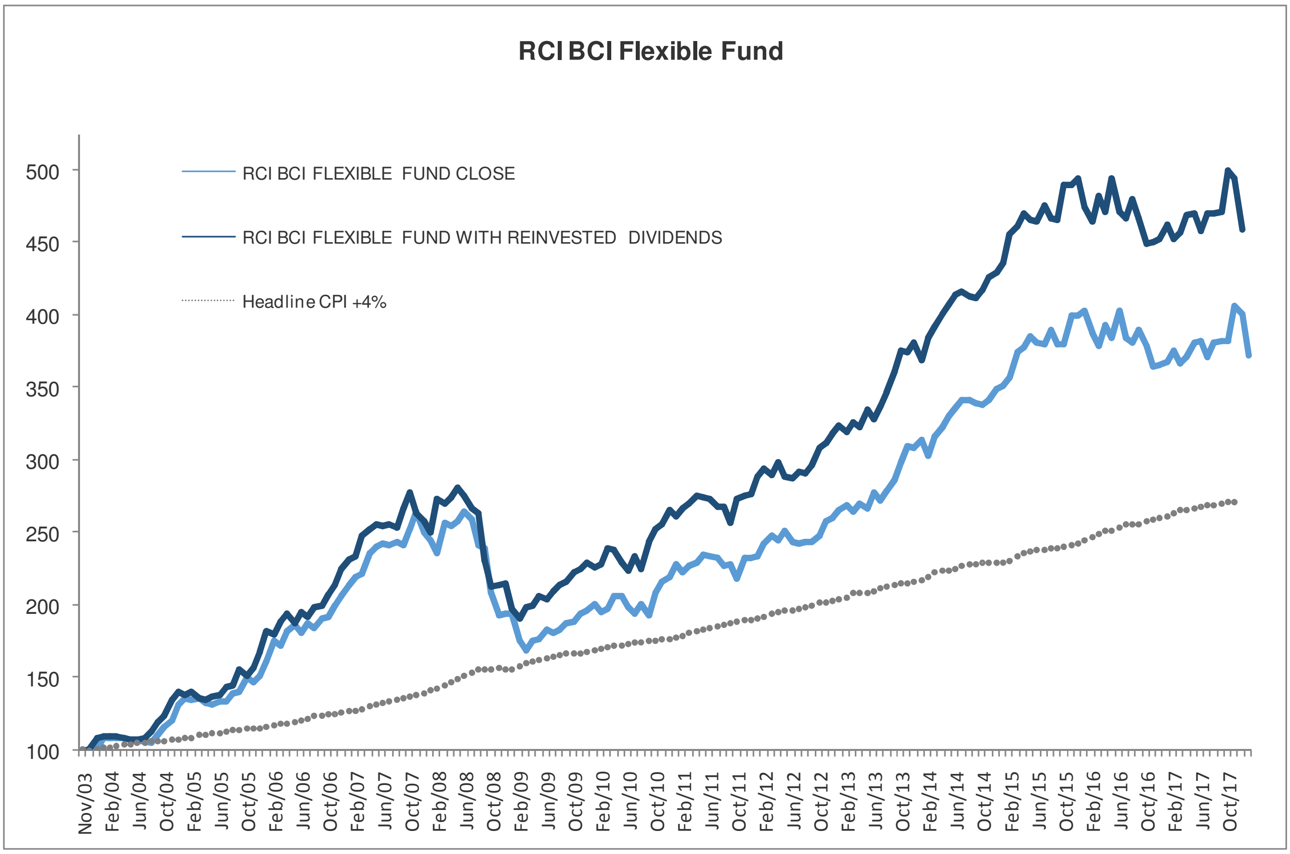
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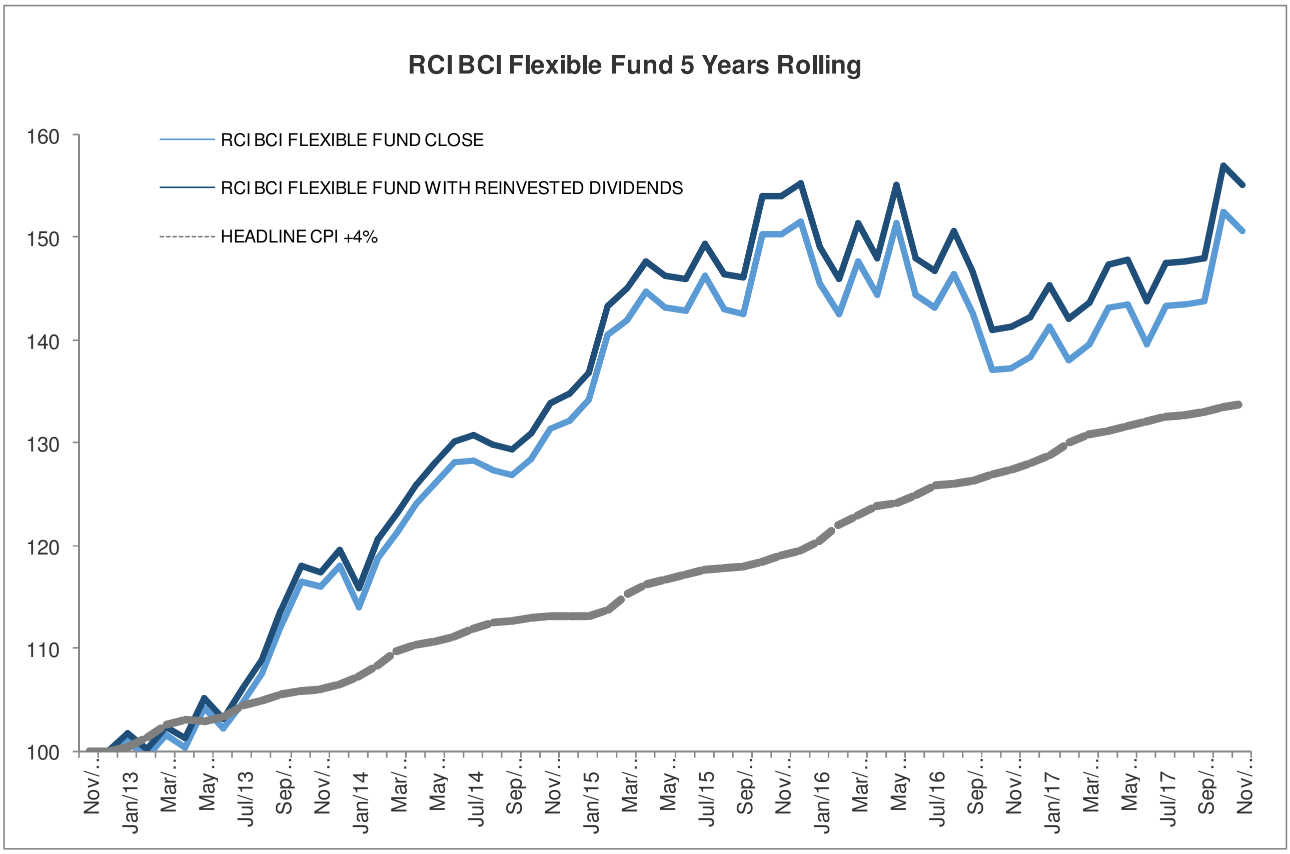
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RCI BCI FLEXIBLE FUND WITH REINVESTED DIVIDENDS
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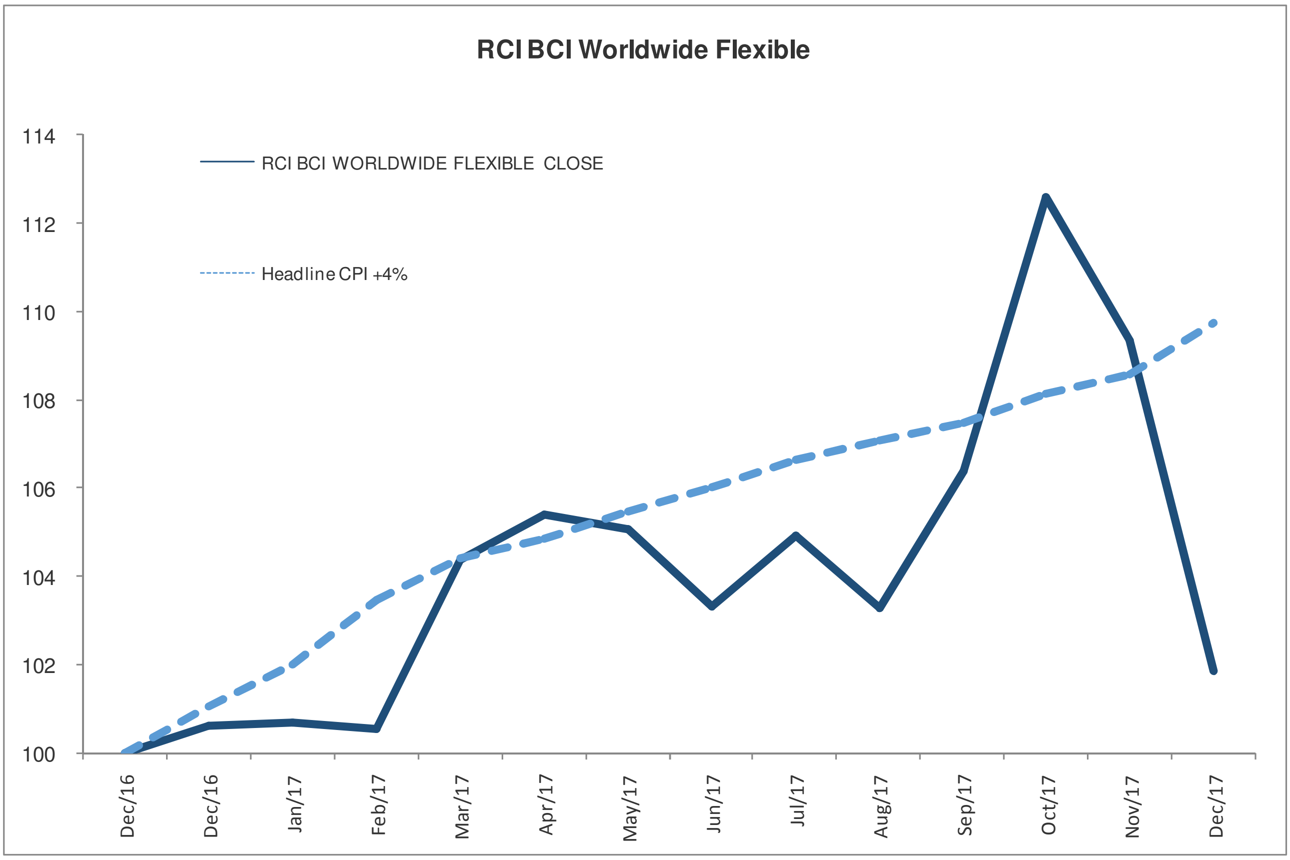
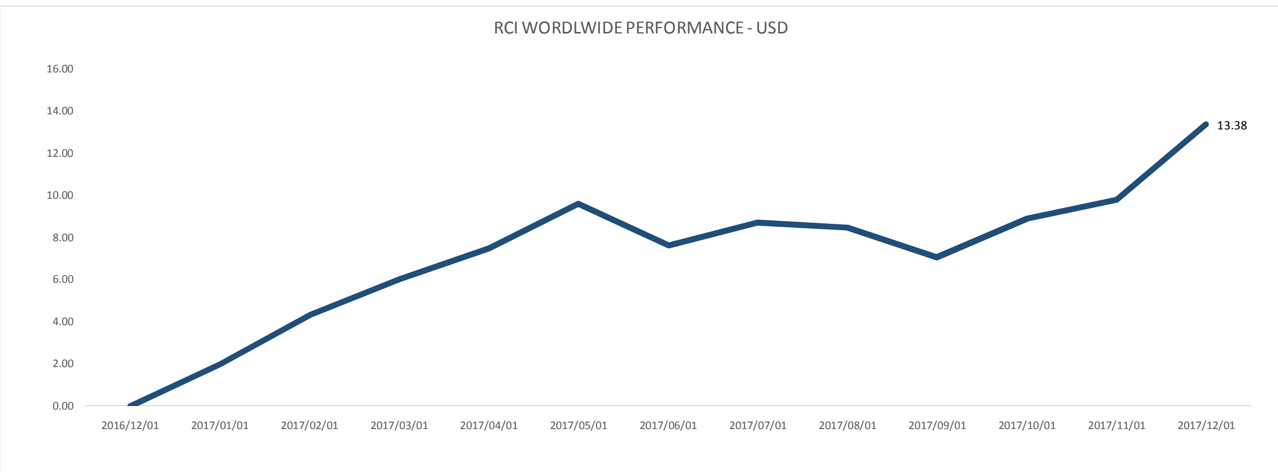
RCI BCI World Wide Flex closed December at 101.87,down 6.84% for the month. The fund rose 1.25% for 2017. We were looking fantastic at the end of October as the dollar performance had been good and the rand was weaker. Suddenly, due to the ANC elective conference in mid-December, the rand strengthened from being down 3% at the end of October to being up 10% by the end of 2017. Hence the drop in the rand value in the solid line below. We believe that the rand will weaken over the next five years so the short-term performance is largely irrelevant. What really matters is how is this fund doing in dollars? It rose 13.4% in 2017 which we were very happy with. We have put in a graph of its dollar performance below the rand chart. There are many short-term risks to the rand (both upside and downside).



Dollar performance of our Worldwide Fund



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 R25 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

2018 is a difficult year to forecast. When will President Zuma leave office? Will South Africa be downgraded? How will the land redistribution work out? Metal prices? USA? The success rate of forecasting is dismal! There are too many variables to be successful in the short term except due to luck. We don’t want to be dependent on luck – we want to invest in the manner which proves most successful over the long term.

Our focus is to protect your capital against rand weakness in turbulent times and to be invested mainly in companies with good, reliable and growing dividends.

We provide continuity from one generation to the next, help you with your taxation and estate duty positions and provide input on how to structure your offshore investments and local trusts to best effect.

We wish all our clients a happy and prosperous 2018.

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

Thank you for being our clients.

Best regards

Di and Alan

How did our outlook for 2017 work out?

We correctly foresaw that the **drought was over** for everywhere but the Western Cape (which is now worse off than ever). This did lead to a drop in food prices and inflation.

As expected, **commodity prices remained stable with some volatility in iron ore prices.**

The rand is always an issue. We thought President Zuma would be unlikely to be replaced before the elective conference in December. We expected that Minister Gordhan would be replaced but no nuclear deal was reached which would have stretched South Africa's credit worthiness.

We expected foreigners to continue to sell our gilts. **"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."**

What we failed to get right was the rand which rose about 10% against the dollar after being down 3% at the end of October. There was a huge relief rally in December in anticipation and following the elective conference. The forecasting risk in the South African market remained high.

What are the main external factors influencing South Africa?

USA - Mr. Trump has changed the outlook!

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. Mr. Trump found out that delivering on his electioneering promises could be difficult but he has managed to get his tax cuts through and the US economy is showing lots of confidence.

We had expected that their fiscal and monetary policy would continue to tighten in 2017 but rates rose very little and the stronger dollar we had expected proved incorrect. The dollar got 12% weaker against the euro which is a huge change. A weak dollar is normally conducive for commodity prices to rise. Our preference for US companies did not work out that well as, due to the euro strength, many European companies did even better. However, US companies with lots of overseas subsidiaries did well.

Our belief 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) proved correct but it did not show the strongest growth in the developed world.

Taking all of these factors into account, we believed the balance of probabilities lay to the upside and we were rewarded with strong growth in dollar terms. The SP500 rose 19%.

Europe - what is the chance of the breakup continuing?

As expected, the UK suffered from higher inflation on the back of a weaker pound. Last year, after the Brexit vote, political uncertainty was expected to spread throughout the rest of the EU. This proved to be somewhat of a damp squib.

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

We correctly expected that the Chinese government would to continue to stimulate GDP growth, and large infrastructure spend continuing causing commodity prices to continue their rise and that profits from locally listed resource based companies – Billiton, Anglo American etc would be fine. This results in more tax being paid by these companies, and in better paid miners, so the economy will slowly pick up. The iron ore price remained extremely volatile.

Our expectation for the year was a 5-10% growth in earnings and similar growth in share prices for both South Africa (which managed 17% in share prices after the relief rally following the ANC elective result) and the USA which rose 19% in dollar terms and about 10% in rand terms. Growth in earning was much more limited, so valuations became more stretched in overseas markets.