# Robert Cowen Investments

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# Newsletter

end March 2017

5 April 2017

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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

"Education is the ability to listen to almost everything without losing your temper or your self confidence." *~ Robert Frost*

"Money, if it does not bring you happiness, will at least help you be miserable in comfort." *~ Helen Gurley Brown*

"The problem with people who have no vices is that generally you can be pretty sure they're going to have some pretty annoying virtues." *~ Elizabeth Taylor*

**RCI MET Flexible Fund** – closed March at 371.51, up 1.23% for the month, compared to the JSE Top 40 which was up 2.35%. The RCI BCI Flexible Fund is 4.96% lower than 12 months ago whereas the JSE Top 40 was down 2.11% versus a year ago. Our fund is more comparable to the FINDU 30 Index which was down 4.2% over the year. As you know, the portfolio is full of rand hedge shares so the past week's events have caused the value of the portfolio to rise 3.7% from 27 March to 378c.

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

**The best way to teach your children about taxation .........**

**Soros on the alleviation of poverty and misery**

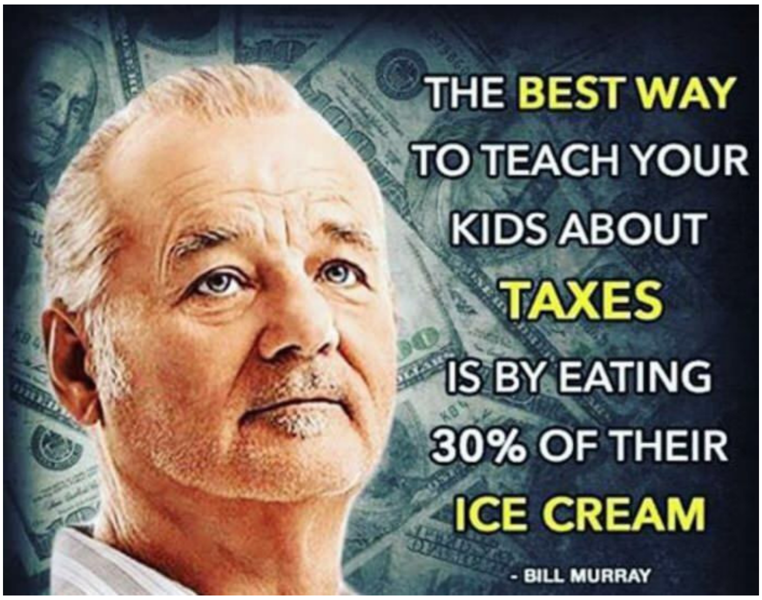
**South Africa – politics might be coming to a head – but it is the metal prices that really count**

**George Orwell** – appropriate words for the current situation

**How we see the US market** – expensive but likely to continue to grow over the next few years

**World Food production is growing faster than population**

**The cloning of the woolly mammoth** – people would much rather have the woolly mammoth than the Euro – amusing comment by David Fuller




## Soros on the alleviation of poverty and misery

"Most of the poverty and misery in the world is due to bad government, lack of democracy, weak states, internal strife, and so on. We do need to intervene, to improve political and economic conditions inside countries that have bad governments, where people are suffering. One way of doing this, without violating sovereignty, is through constructive actions — reinforcements and incentives for countries that are moving in the right direction, toward an open society, a market economy, et cetera. That is what I'm advocating. I'm advocating preventive action of a constructive nature. And I would use military force only as the very last resort, when nothing else works." ~ George Soros

## South Africa - politics might be coming to a head - but it is the metal prices that really count

The firing of Mr. Pravin Gordhan as Minister of Finance has got the SA world in a spin. The rand has fallen 10% from R12.40 to the dollar last week to R13.60 on 4 April. Our best guess is that it will go to somewhere between R14 and R15.

Why won't it go to R16 as it did at the beginning of 2016? Because the prices that export industries are getting for their products are just so much higher now than a year ago.

In an update to investors following the recent cabinet reshuffle, research analyst firm Nomura said that it had long held the view that the market underestimated Zuma's political strength, and put far too much focus on positive hopes, rather than facing the more dampened reality.

RCI concurs with that opinion, for the past two years we have said that we doubt President Zuma is going anywhere. He controls his party well. This is what we had written in a review, last week:

"The threat of a sovereign ratings downgrade in June or December 2017 still 'hangs' over the Rand in the short term. This, coupled with the possibility of a cabinet reshuffle, tilt the balance of probabilities to the downside for the rand.

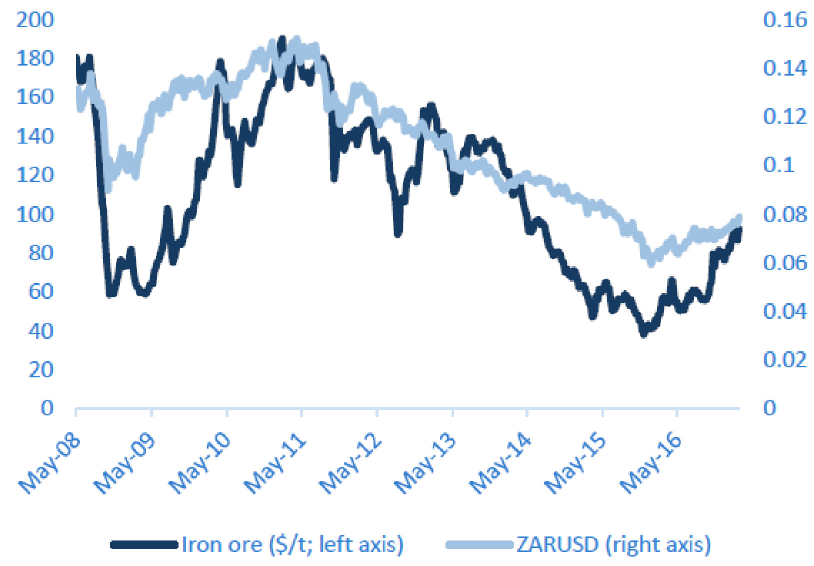
The next commodity cycle should only begin around 2030. The mines are unlikely to be able to export strongly without a weaker rand and will not pay much tax. This will result in a budget shortfall which is problematic when South Africa has so many people on welfare.

SA's export industries are (in order of size):

1. Iron ore; 2. Coal; 3. Platinum; 4. Motor cars; 5 Tourism; 6. Diamonds; 7 Agricultural products; 8. Gold. With the exception of tourism and agricultural products (which are erratic) we think the other exports are likely to battle.

In contrast, a growing US economy and strengthening US currency (especially on the back of Donald Trump being recently elected as US president) could result in pressure on the rand."

**Strong Correlation between the Rand and Iron Ore prices**




Source: Anchor

Over the past year, metal prices have jumped off their bottoms but we expect them to bounce along the bottom for many years to come. A short-term bounce does not change the direction of the economy. Most people cannot look more than six months forward so are continuously getting whiplashed. We try to formulate a long-term plan based on the most likely long-term economic fundamentals and then stick to it, unless economic fundamentals change. Unfortunately, what is currently occurring is within the bounds of our view!

**Conclusion:** speculating how things are going to turn out in the short-term is a bit akin to gossiping. It is fun but does not really add value to the investment case. We prefer to look at longer term issues and identify trends. So for example, looking at the evidence of the last century and the current over supply of metals, we can predict with a fair degree of certainty that the iron ore price is likely to remain under pressure. Whereas, where it will be a year from now, is anybody's guess. Long term demographic trends give investors a fair idea where a market is likely to be in ten years' time.

Likewise, predicting that a great company with a high return on equity, good free-cash flow, a strong balance sheet, great products and good management is more likely to continue to do well is less risky than betting on a company with a low return on equity, poor cashflow, a weak balance sheet and bad management. As Warren Buffett's mentor famously said "In the short run the market is a voting machine but in the long run it is a weighing machine". Our clients are mainly retired people. We try to be a weighing machine!

RCI is well positioned for any rand weakness. In our RCI BCI Flexible unit trust we have 25% in direct offshore holdings and many other rand hedges. In our individual portfolios we have over 50% of each portfolio set up to benefit from rand weakness. The very things that made us outperform so strongly from 2012 to 2015 i.e. eschewing mining and banking on rand weaknesses, did not work in 2016 because of the strong rand and the improvement in metal prices (which, unfortunately, we think is temporary). So, a resumption of the trend in rand weakness should suit for portfolios.

## The events of the past week bring to mind the lines from the famous "Animal Farm"

"Day and night we are watching over your welfare. It is for YOUR sake that we drink that milk and eat those apples. Do you know what would happen if we pigs failed in our duty? Jones would come back! Yes, Jones would come back! Surely, comrades, ..."
~ George Orwell

## Investing in the United States

Ross McConnochie

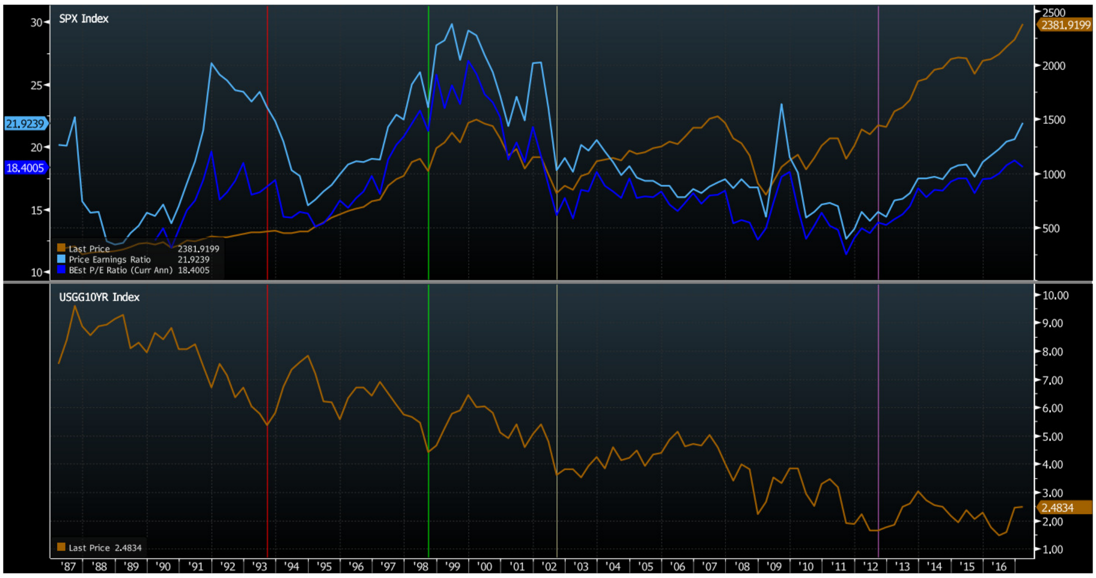
The American stock market is difficult to value at the moment. It is hard to sift through all the noise when so many writers scramble to use language like "biggest drop in the S&P500 this year" to attract readers. After the run it has had, these small pullbacks are warranted and, actually, are a relief because a stock market that stretches too quickly upwards in one direction without any significant down days can have a shock correction. It is normally like a "rubber band" snapping back into line.

Trying to time this market is difficult because there is so much more at play than just the underlying fundamentals of the companies we invest in. Can Trump pull off his endeavour to drop taxes? Many industries are already priced as if the tax declines will definitely occur. What happens if he cannot get the tax reductions passed?

If there is a drop in the tax rate soon, you should be invested in the USA. The Republicans are supportive of tax breaks so Trump should be able to get it done in the end. Whether it takes place this year or next is the real question. We just don't know at this point.

Why do we currently like the USA even though the US valuations are expensive? The US stock market might continue to run and to reach valuation levels that we have not seen since the Global Financial Crisis. The balance of probabilities is that US growth will continue so we wouldn't want to bet on a large pull back yet. We think it might weaken by about 5%, then resume its upward trend. Economic growth in the USA remains positive.

**S&P500 – 30 year graph**



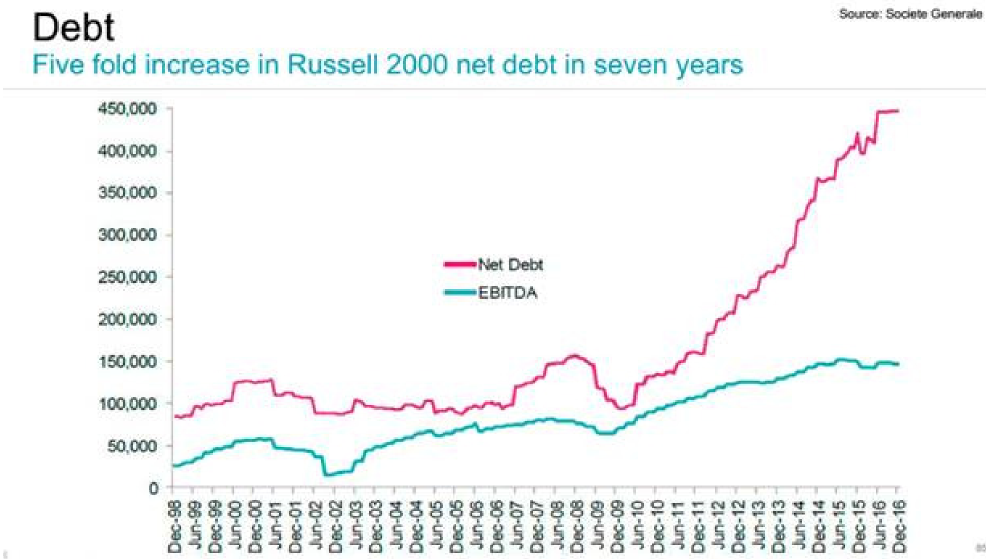

Source: Bloomberg

(Light blue = PE ratio; Upper Brown line = Market Price; Dark Blue = Forward PE ratio; Lower Brown line = US 10 year bond yield)

The above graph is a little busy so let us work through it slowly.

- The light blue line is the price earnings (PE) ratio of the S&P500 over the past 30 years. The price earnings ratio is a measure of how expensive a share or stock market is and it important to look at the history of the PE ratio in order to gauge how expensive the stock market is at the moment. We are approaching the 2009 and 1999 levels. So we are above average expensive at the moment but this can easily get more expensive as the bit is between the bull's teeth.
- The lower brown line (bottom graph) is the US ten year bond yield. Every significant period of interest rate increases over the past 30 years resulted in stronger stock markets (red, green, white and purple vertical lines). Rates go up because of an improving economy and inflation but the theory also goes that companies who have been sitting on ideas and expansion plans have been waiting for the economy to improve and when rates start to rise they take out debt and lock in the cheaper rates and thus starts a new improved period of expansion. Since we are currently in a hike cycle this is good news for equity investors.

However we have seen graphs indicating that US companies are severely indebted and consequently cannot gear the portfolios any more (some might say one should reduce their debts by the high cash holdings of these companies, so have used the net-debt level):




Source: Stanlib Asset Management

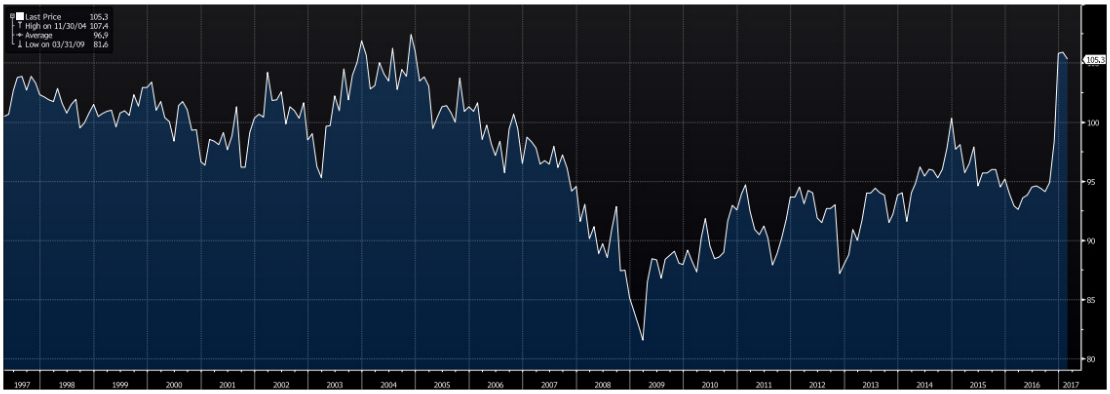
So there is a worry that the mainly pure US companies (Russell 2000 is the US small cap index) are extremely indebted at the moment. This is not the case for the larger companies in the USA. The implication of this is that that small companies are unable to take out much more debt at present but we can see from the graph that this level of debt was increased largely at lower interest rates post the financial crisis.

There are several other factors that are positive for the US at the moment:

- End of bond bull market: We have of course had a 30 year bull market in bonds and if that trend is now broken and rates continue to rise (albeit at a slow pace) we could very well see large flows into US equities even at the current price levels.
- Rates are still so low: Consumers are not severely impacted by these small rate hikes at this time. We recently had a call with Home Depot's investor relations team and they mentioned that they would only start seeing impact to the consumer once rates were hiked several percentage points from here. So these small rate hikes are not too detrimental to the average American's disposable income.
- Inflation is picking up: This triggers all kinds of stimulus, growth and investment around the US.
- Corporate tax cuts should improve earnings: After tax earnings are expected to increase 4% for every 5% tax cut from the current 35% level. So immediately the earnings prospects would improve and thus PE ratios wouldn't be so pricey.

- Repatriation of cash held by companies offshore: Could result in huge flows into the States and consequently large special dividends and/or share buybacks. These include Apple, Pfizer and other global tech and pharma companies who have large cash balances offshore, who refuse to transfer to the USA at current high tax levels. This would lead to increased tax revenue and cash injections into the US economy. This could lead to a strong dollar with the negative side effect of making US exports less competitive for the short to medium term.
- A massive spike in small business confidence: The heart of the USA, and the true reflection of the average American, is the small business confidence index which is currently around twenty year high levels. America is thus very optimistic about the future:

**Small Business Confidence**



America is expensive at the moment but we believe economic conditions are improving and thus the valuations are warranted. However, we also believe that the market is priced to perfection on Trump's influences. So we would likely see a pullback in the near future if tax reforms don't happen soon or there are any setbacks in the reflation plans via infrastructure spend. The US is also a better bet than Europe where major political upsets are possible and growth prospects are stagnant. There is a major emerging market theme at play in the global investment community which helped strengthen the Rand of late but we believe our clients have enough exposure to emerging market risks with South African investments and their sensitivity to commodity prices. For our offshore exposure we will continue to focus the majority of our clients' investments in the USA until such time as valuations become extreme or value is found elsewhere.

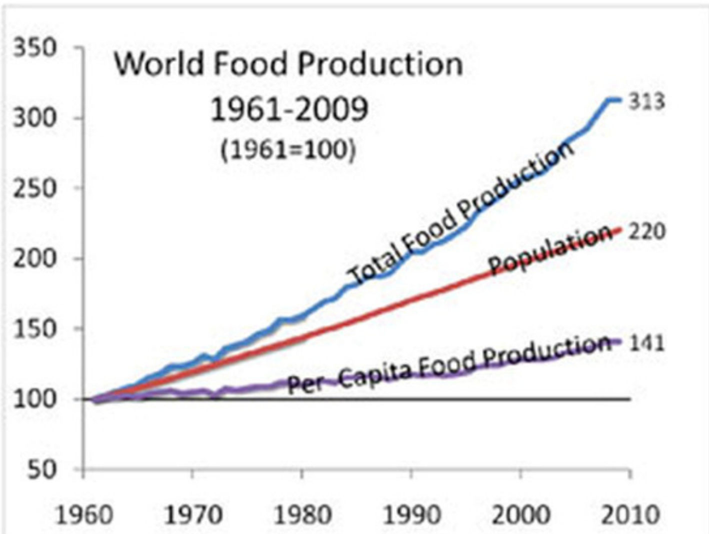
## World Food production is growing faster than population

From: The passing parade by David Gallant 17th February 2017

Refuting the Malthusian argument that we are all DOOMED, David Lam of the University of Michigan's Population Studies Center put together a presentation that you can watch here (https://www.youtube.com/watch?v=dBwv2tjZFuM).

In it, he includes the slide alongside, which he explains as thus:

"The world is producing three times as much food today as in 1960; the population is two times what it was in 1960, so there's 41% higher food production per capita."




**Editor**: We do not want to get into any arguments on GMO but simply wish to point out that food supply has been growing much faster than population and the earth is not going to run out of food any time soon.

## How the Euro Could Break Up or Be Saved

Fuller Treacy Money of 08 March 2017: David Fuller's comment on the How the Euro Could Break Up or Be Saved was priceless.

Natural scientists are now talking about the real possibility of cloning a woolly mammoth and possibly various varieties of dinosaurs, so it is not beyond the bounds of imagination to assume that the euro could be kept alive for a few more years before it becomes extinct.

The problem, however, is that Europeans would much rather have the woolly mammoth than the euro.

> "Time is the most valuable coin in your life. You and you alone will determine how that coin will be spent. Be careful that you do not let other people spend it for you." ~ Carl Sandburg

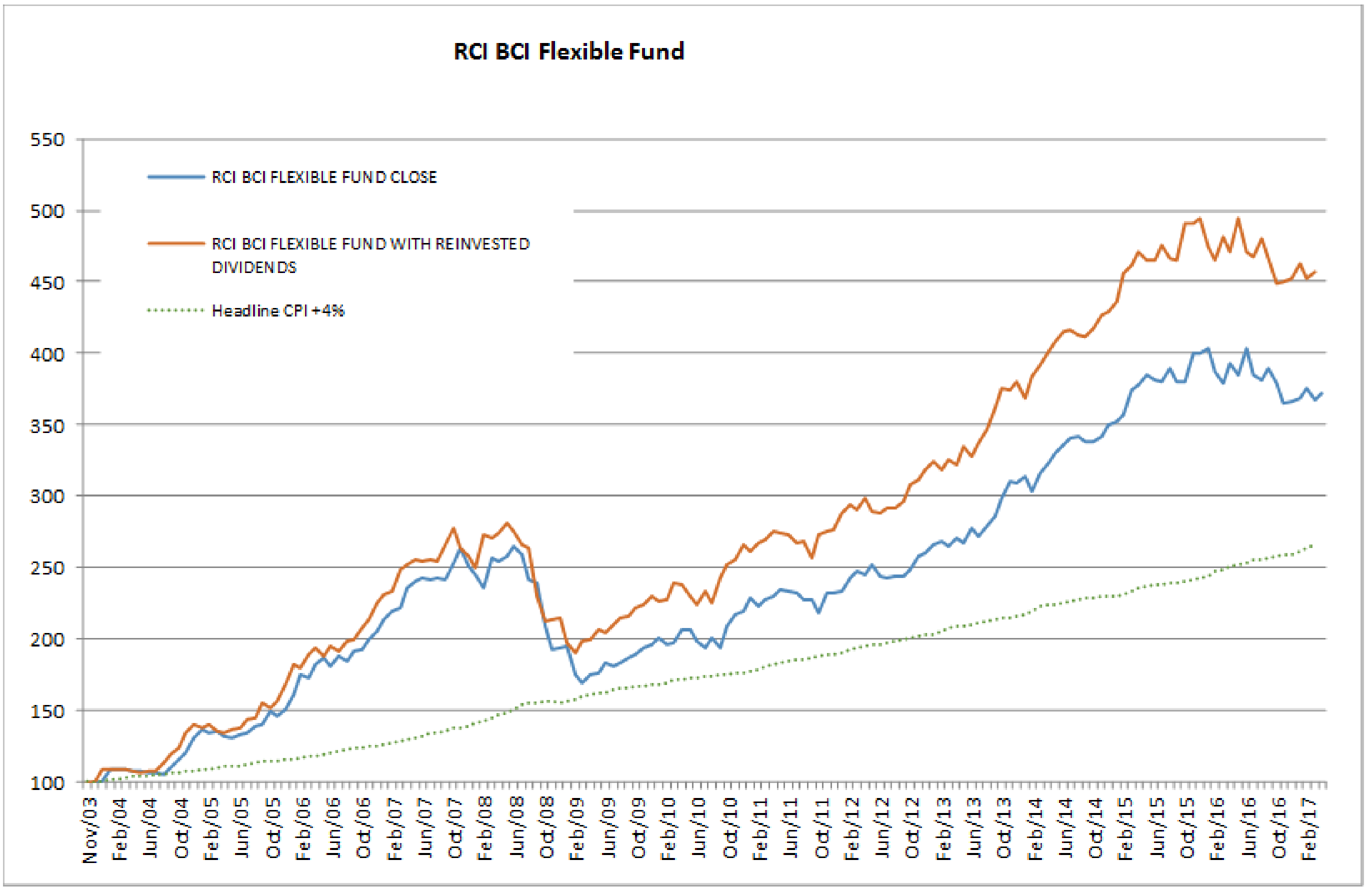
## RCI BCI Flexible Fund

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

RCI BCI Flexible Fund closed March at 371.51, up 1.23% for the month, compared to the JSE Top 40 which was up 2.35%. The RCI BCI Flexible Fund is 4.96% lower than 12 months ago whereas the JSE Top 40 was down 2.11% versus a year ago. Our fund is more comparable to the FINDU 30 Index which was down 4.2% over the year.

We have set up our portfolio to benefit from a weaker rand. From the 27th March until 4th April, our fund has risen 3.7% due to fall in the rand.

We are investing for the long-term in companies that should enjoy reliable growth in earnings and dividends. Sooner or later, this should be translated into good share price growth.



**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.

Collective Investment Schemes in Securities (Unit Trusts) are generally medium to long term investments. The value of participatory interests (units) may go down as well as up and past performance is not necessarily a guide to the future. Unit trusts are traded at ruling prices and can engage in borrowing and scrip lending. A schedule of fees and charges and maximum commissions is available on request from the company/scheme. Commission and incentives may be paid and if so, would be included in the overall costs. The portfolio is registered under the license of Boutique Collective Investments, a member of the Association for Savings & Investment SA. Forward pricing is used. More details are contained in a fact sheet that is available on request.

**To conclude**

What a difference a week makes. Some clients were wondering if our good performance in portfolios was something of the past. We were at pains to point out that the excellent performance of 2010 to 2015 was because we felt the rand was going to weaken and that rand hedge and offshore shares were likely to be good, while mining shares were likely to be poor.

We did not change our strategy but in 2016, the rand strengthened and metal prices jumped! Thus our portfolios were not set up to perform. Firstly, it is often difficult to change a portfolio too radically. Many portfolios have tax consequences to bear in mind. Secondly, mining shares jumped so rapidly that if you missed the first month, you missed most of the rally and we doubt that the long-term bear market in metal prices is going to conclusively turn around for many years. Thirdly – the rand. Our expectation of a weakening rand was suddenly rewarded in the last week. Therefore we still have not changed our strategy – over the longer term we continue to expect metal prices to be under pressure and the rand to weaken.

It is sad that one has to benefit by betting against the financial well-being of our country but until the President and his ministers start behaving in a manner which results in long-term growth, a weakening currency is the most likely outcome. If South Africa's inflation rate is 6% and the developed world is 1% then expect a 5% per year deterioration in our currency. In 2016, the prices of our exports rose so strongly that the rand strengthened. Then politics came into play!

Please remain calm, things are never normally as bad (or as good) as the press makes out at the extremes. Most things settle down after a few months if they are pushed too far from the trend-line. Guessing the short-term moves of market is speculating whereas working out the long term direction of the trend line, and altering one's balance at extremes, is investing. The rand is not even above R14 to the dollar. It is not nearly as extreme as the R16 to the dollar at the beginning of 2016.

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

Thank you for being our clients.

Best regards

*Di and Alan*

"Advice is what we ask for when we already know the answer but wish we didn't." ~ Erica Jong