Robert Cowen Investments

Growing families' wealth since 1982

Authorised Financial Services Provider FSB Licence No. 701

Newsletter

end October 2017

8 November 2017

Contact us:

Alan McConnochie

+27 11 591 0551

083 378 3463

alan@rcinv.co.za

Di Haiden

+27 11 591 0572

083 308 7928

di@rcinv.co.za

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

"Champions keep playing until they get it right." ~ *Billie Jean King*

RCI BCI Flexible Fund – closed October at 405.9, up 6.07% for the month and, with the drop in the rand over the past two weeks, is now at 410.02c. The Fund is up 11.6% for 2017 to 8th November. It was up 10.98% year to date to the end of October, whereas the Consumer Price Index rose 4.22%.

RCI BCI World Wide Flex closed October at 112.6, up 5.85% for the month. The fund is up 12.99% year to date. This unit trust is invested in about 20 world-class companies. Most have a very high ROCE (return on capital employed) of over 40% (pre-tax) whereas it is hard to find South African companies producing over 20% ROCE. These types of companies produce strong, and growing cashflows, often with a high and consistent dividend. Most are household names such as Nestlé, Apple, Microsoft, Johnson & Johnson. When they get too expensive, we trim some off the top and seek to reinvest when the price stops falling. The growth in dollars has been good over the past 10 months so when the rand weakens, we expect the performance to be good.

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

It is horrible to be proved correct. Mini-budget brings home risks facing South Africa

Following the mini- budget in October, the rand fell significantly and the country is now expected to suffer a downgrade – some believe as soon as 25th November, which could result in further rand weakness as many foreign investors will be forced to sell their South African bonds.

We have expected this development for years as government policies have never been adapted for the much lower tax that lower metal prices will result in. The Government has increased employees, their salaries and social pensions and have had to increase borrowings to do so. Now, with tax revenue declining, we have reached a point where it is difficult to increase borrowings by the amount required each year.

In anticipation, we have increased off-shore investments and rand hedges in client portfolios. In the tax year to February 2017, this did not work out so well as the rand strengthened and mining shares (in which we were lightly invested) did well. We think that many investors were only looking at the short-term and ignoring the medium-term threats. Suddenly, since the middle of October, the chickens have come home to roost and the rand has dropped – causing our client's portfolios to rise in value. We expect this trend to continue.

Please don't get too bearish! South Africa has been through many tough times in the past. Local shares may over-react and might become good value at some time in the future when we will reinvest in them.

How sad it is to be correct

Some years ago, we concluded that unless South Africa did something, the country would eventually be downgraded. At that point, any far-sighted Government would have instituted policies to avoid this happening. Unfortunately, it is not human nature to look at the resource cycle and forecast a drop in earnings for the country. No Minister wants to be the harbinger of bad news. Nobody wants to face up to the fact that doing well what you did yesterday is not going to cut it in the future when circumstances have changed! It is easier to blame everyone else than to take corrective action because this action might result in you being voted out of office. So, did South Africa curtail government spending, increase VAT and get into good shape for the coming ‘seven bad years’? This cycle is nothing new - it has been going on since biblical times. It is not new, but any resource based economy will suffer from it.

No, South Africa did not take corrective action when it could have, so now we have to pay for this by trying to borrow more money (but no one wants to lend us more as we have already borrowed to much), cutting government expenditure (but we have not built the dams and electricity supplies that we so desperately need), or reducing social pensions (too few taxpayers and too many recipients). The price of metals (not our government’s fault but it hugely drops the tax revenue) is likely to remain weak until about 2032 so to keep our mines in production, we need a weaker rand - and this we shall get!

The mini-budget of October 2017, finally brought it home to most people that South Africa has run out of money and that its strategy of borrowing more to fund expenditure is not sustainable when metal prices are weak and unemployment so high. The third rating agency is now expected to drop us to junk before the end of November. If South Africa is rated ‘junk’, many of the world investment funds will no longer be able to own South African bonds and will have to sell about R150bn that they have invested in South Africa’s government bonds. This is likely to cause the rand to fall, probably to R15 or R16 to the US $. Nobody knows how much the rand will fall, partly because many other countries e.g. Brazil and Russia, are already in bad shape yet our interest rates are close to theirs, so why then should our currency fall too much in the short term? It is not very comforting to rely on everybody else being worse!

Nonetheless, foreigners could easily panic out of our bank shares, pushing them to attractive levels just as they did in the 1980’s. If our banks shares overshoot by, say, 15% to the downside, some high dividend paying bargains may then present themselves. When will this occur? Some people think we may be downgraded during November 2017, others think we might postpone the evil day to December or June 2018 but we have believed for some years that the country is going over the financial cliff and it is better to be a year early, than one day late when it comes to your investment strategy.

Over the long term, we expect substantial pressure on the rand as mining prices should remain weak. This does not mean they will not be volatile. They can bounce along the bottom with substantial velocity as the world slowly works through its massive oversupply problem. The actions the Government might take will exacerbate or relieve some of this pressure. If the country stops wasting billions in bad administration, corruption and bad BEE deals, things will be a little easier but don’t hold your breath – the outcome of the December elective conference or even the 2019 election is not a ‘magic bullet’. No matter who wins the election, it is going to take many years of consistently well applied policies to make much difference. Things can be broken in a flash, but it takes many decades of persistently doing things correctly to have a positive impact. Education is a perfect example: BEE pulled all the competent teachers out of the system in the early 1990’s, we closed the teachers training colleges and now we wonder why the system is so bad. It will take at least ten years of persistent and consistent effort to fix this but first the government must have the political will to take on the powerful unions that allow such poor teachers to persist in their jobs.

Please don't be too pessimistic. We have survived all of this before! South Africa faced a very tough decade from 1980 to 1990 when it was bad to be a miner after the metal boom ended and the politics were worse than now, but, somehow, the rest of us survived. You just don't want to be a poor, uneducated person with no employment prospects. Our strategy is to 'live in the sun but invest in the shade' until the prices of shares 'in the shade' overshoot to the downside and prospects turn good again. Some industries, such as tourism, will benefit from a weak rand. Now we just need some water in Cape Town for the tourists to shower in!

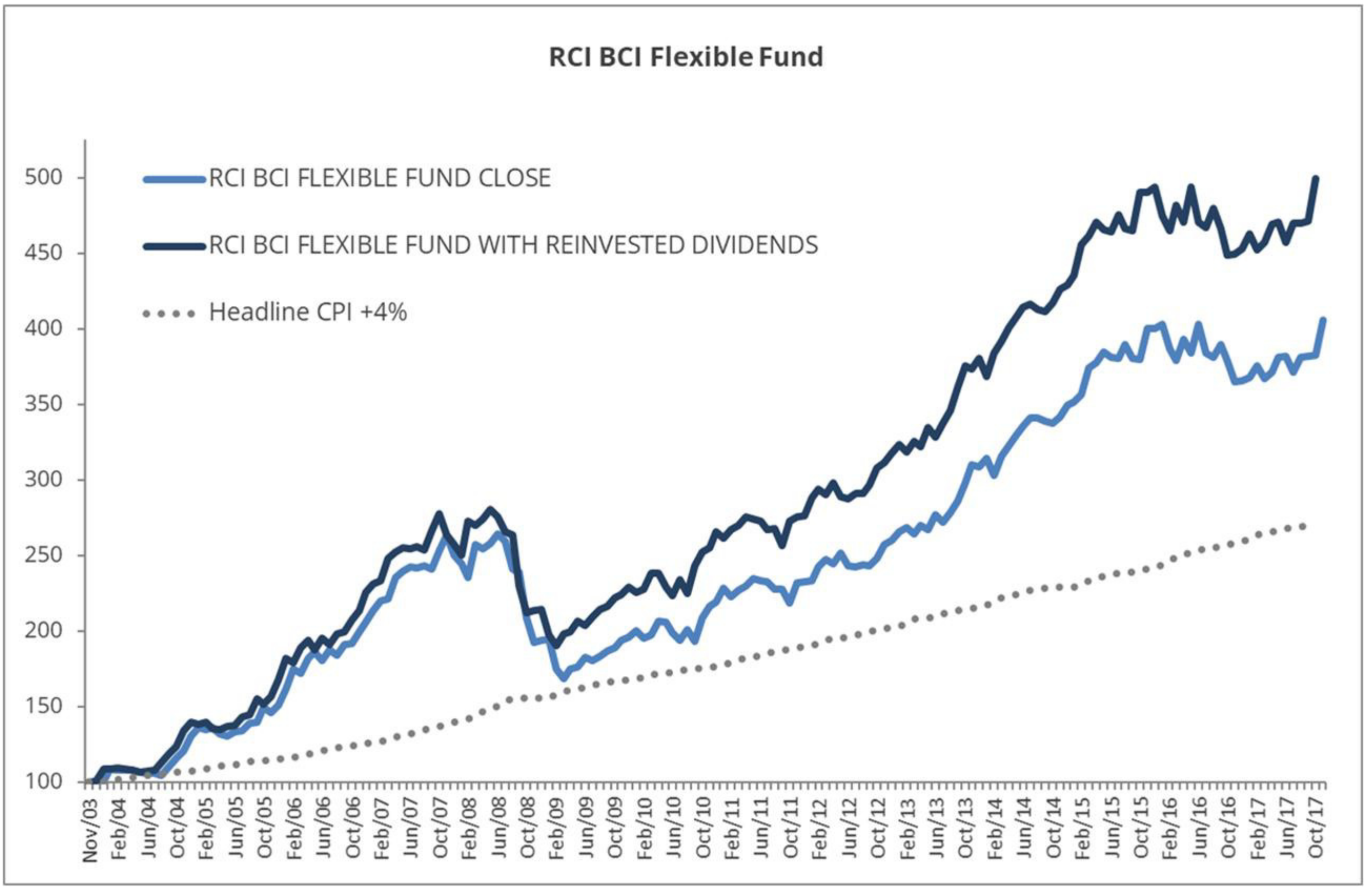
Rest assured, the sun will still come up in the morning and we have invested a lot of your money in rand hedges and offshore shares. Do you realise that the JSE should rise if the rand gets weak? This is because our five largest shares (except for Anglo in fourth spot) have little or no assets in rands e.g. Naspers is about 22% of our Top Forty shares and derives about 140% of its value from its investment in Tencent in China. Its South African assets are effectively for free! Richemont, Billiton, British American Tobacco have no or minimal assets in South Africa.

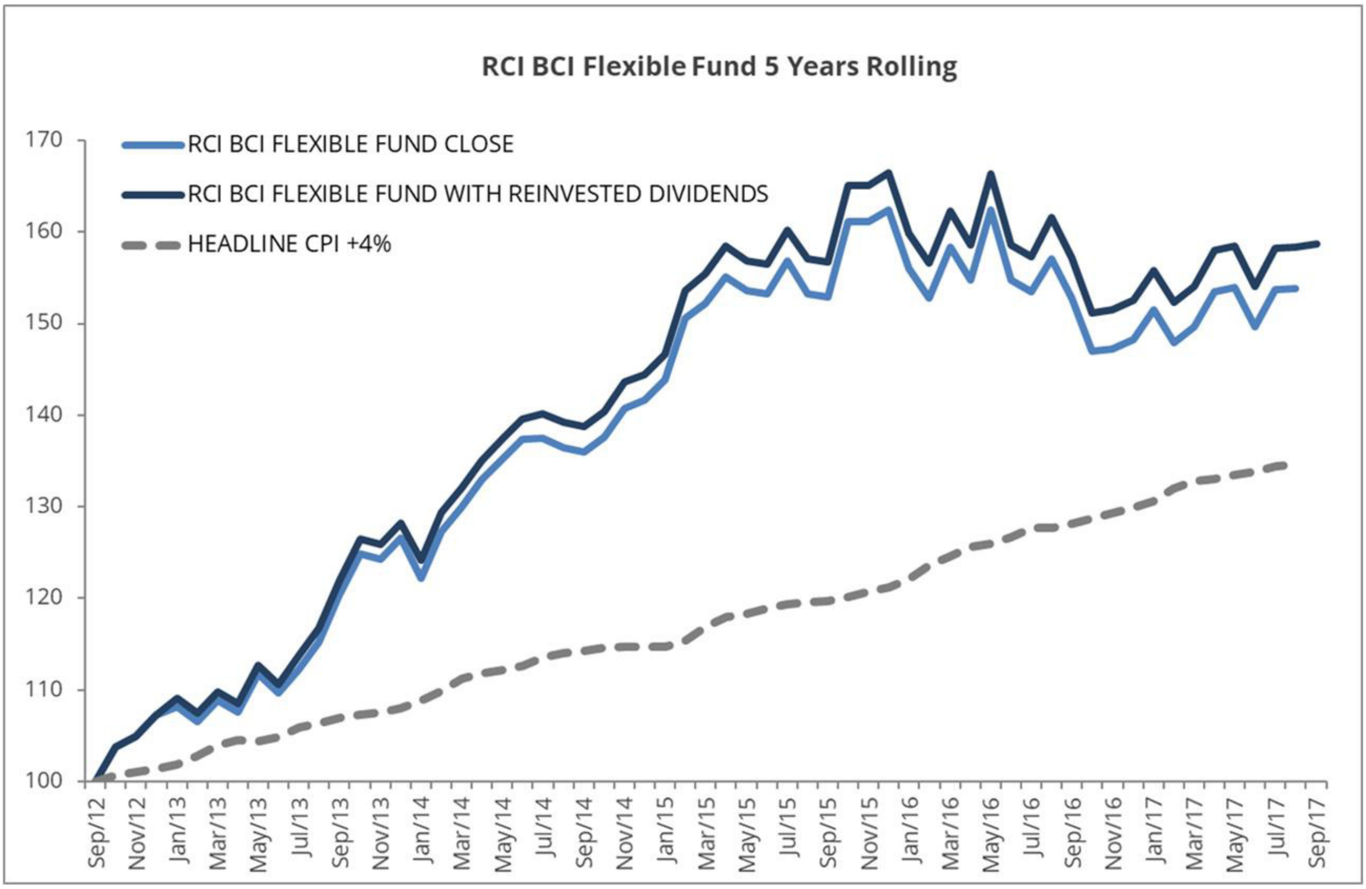
Thus, our portfolios are well placed if the rand weakens. It is sad that we must invest this way to do well over the next few years but eventually the wheel will turn and shares such as Mr Price will, once again, become good value.

RCI Unit Trusts

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

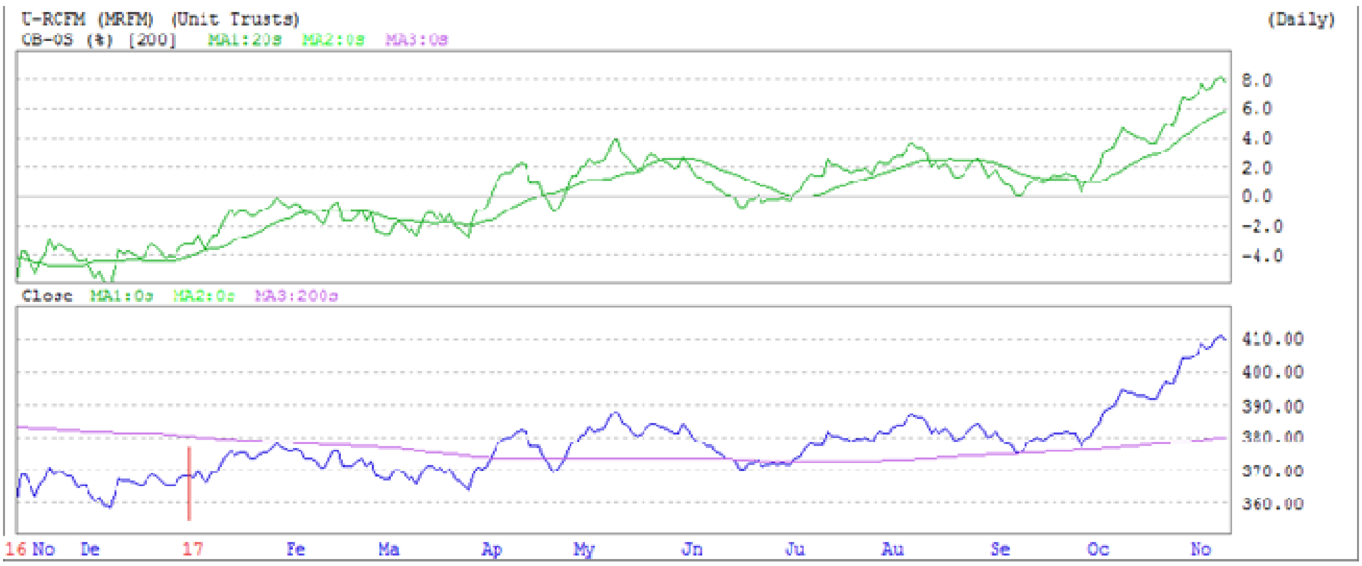
RCI BCI Flexible Fund closed October at 405.9, up 6.07%% for the month The Fund is up 10.98% year to date, whereas CPI year to date is up 4.22% to the end of October.



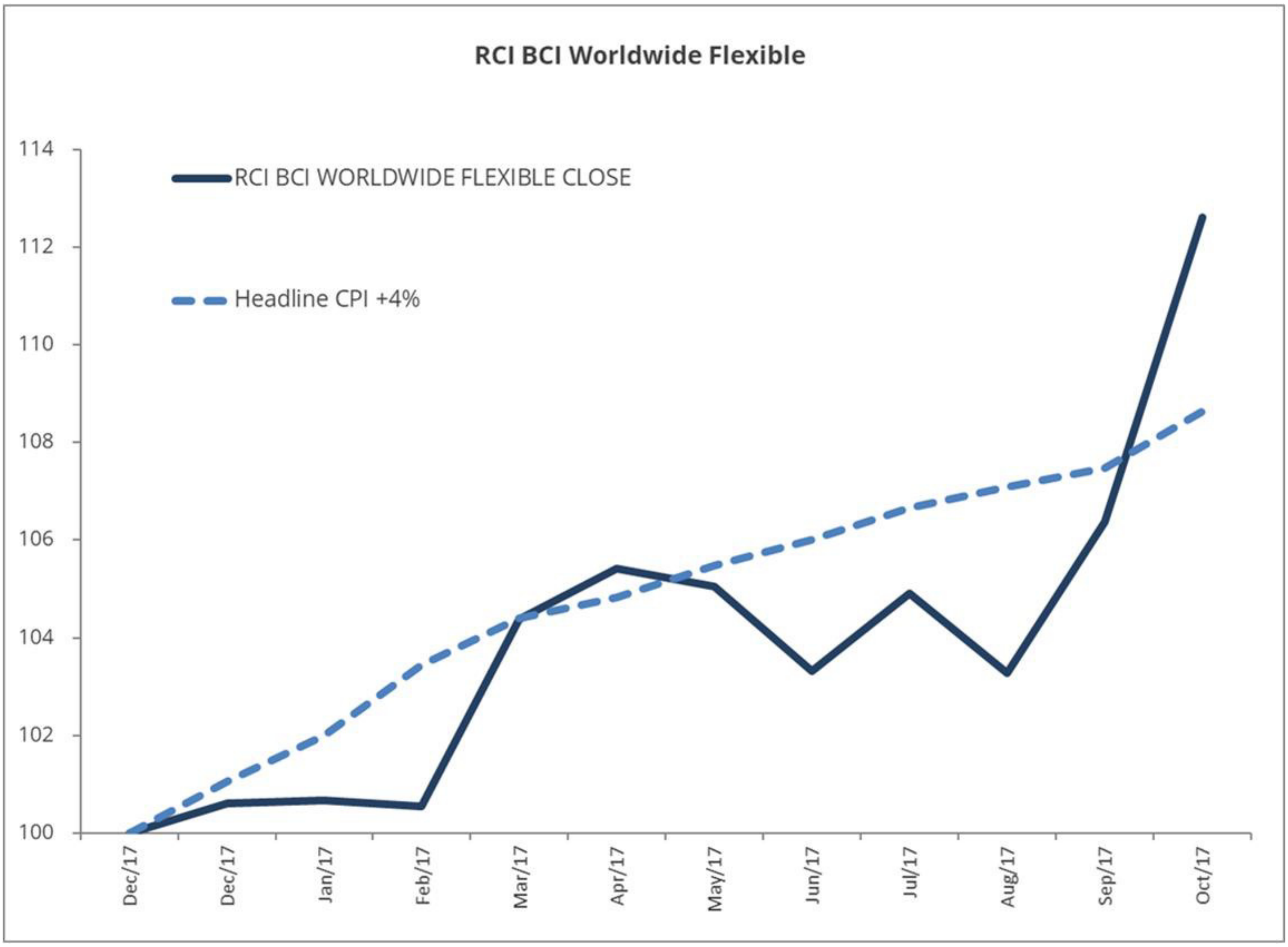


In the graph below, please look at the move upwards over the past two weeks. We have set up the portfolio to benefit from rand weakness, and you have suddenly seen some of this. The bottom chart shows an 11.6% increase for 2017. The top chart shows how little downward volatility there is in our performance - it is consistent, just as most of our clients like it. For 2017, the Oversold index started at -4% and is now up at 8% overbought.

RCI BCI Flexible unit trust – one year performance – up 11.6% in 2017



RCI BCI World Wide Flex closed October at 112.6, up 5.85% for the month. The fund is up 12.99% year to date.



This unit trust is invested in about 20 world-class companies. Most have a very high ROCE (return on capital employed) and strong, and growing cashflow. Most are household names such as Nestlé, Apple, Microsoft, Johnson & Johnson. When they get too expensive, we trim some off the top and seek to reinvest when the price stops falling. The growth in dollars has been good over the past 8 months so when the rand weakens, we expect the performance to be good.

RCI BCI World Wide Flex – short term performance

The graph is only available from May but you can see how the rand value has jumped over the past two weeks due to the drop in the rand post the interim budget, from 102c in early September to 113c at 7th November. As we always say, when it comes to the rand collapsing, we would rather invest one year early than one day late! Many commentators are now expecting the rand to weaken before the end of November as they think the rating agencies will downgrade South Africa to junk.

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

The mini-budget appears to have been a tipping point in investment thinking. For years, forward thinking people could see the problem coming but the investment press, and much of the investing public, ignored the problem and the likely outcome. We foresaw the long-term outlook for South Africa as daunting, with pressure on metal prices due to vast oversupply, worsening politics in South Africa, huge unemployment and problems unfolding in electricity and water supply. For this reason, we increased offshore exposure and/or rand hedge investments to well over half of most portfolios.

During 2016, most of these problems were ignored by the press and most investors so the rand got stronger and many South African shares improved strongly. This did not suit our strategy for the tax year ending February 2017. Now, however, the weak rand and 'sudden concerns' over the economy are causing our portfolios to do well.

We are saddened by having to invest in offshore shares because of concerns over the medium-term future of South Africa. We would point out that our country has survived many crises in the past and will no doubt survive many in the future. Once share prices have properly corrected to mirror the underlying economic fundamentals, we look forward to being able to reinvest in South African operations. In the meantime, we are very happy to have lots invested offshore and/or in rand hedges.

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

Thank you for being our clients.

Best regards

Di and Alan